Rulemaking File

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Sales and Use Tax

Regulation 1525.4

Manufacturing and Research & Development Equipment.

OAL Disapproval

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DEBRA M. CORNEZ
Director

MEMORANDUM

TO: Richard Bennion
FROM: OAL Front Desk
DATE: March 24, 2016
RE: Return of Rulemaking Materials
OAL Matter Number 2016-0104-01
OAL Matter Type Regular (S)

OAL hereby returns the rulemaking record your agency submitted for review regarding "Manufacturing and Research & Development Equipment."

If this is an approved matter, it contains a copy of the regulation(s) stamped "ENDORSED APPROVED" by the Office of Administrative Law and "ENDORSED FILED" by the Secretary of State. The effective date of an approved regulation is specified on the Form 400 (see item B.5). **Beginning January 1, 2013**, unless an exemption applies, Government Code section 11343.4 states the effective date of an approved regulation is determined by the date the regulation is filed with the Secretary of State (see the date the Form 400 was stamped "ENDORSED FILED" by the Secretary of State) as follows:

(1) **January 1** if the regulation or order of repeal is filed on September 1 to November 30, inclusive.
(2) **April 1** if the regulation or order of repeal is filed on December 1 to February 29, inclusive.
(3) **July 1** if the regulation or order of repeal is filed on March 1 to May 31, inclusive.
(4) **October 1** if the regulation or order of repeal is filed on June 1 to August 31, inclusive.

If an exemption concerning the effective date of the regulation approved in this matter applies, then it will be specified on the Form 400. The Notice of Approval that OAL sends to the agency will include the effective date of the regulation. The history note that will appear at the end of the regulation section in the California Code of Regulations will also include the regulation's effective date. Additionally, the effective date of the regulation will be noted on OAL's web site after OAL posts the Internet Web site link to the full text of the regulation that is received from the agency. (Gov. Code, secs. 11343 and 11344.)

Please note this new requirement: Unless an exemption applies, Government Code section 11343 now requires:

1. Section 11343(c)(1): Within 15 days of OAL filing a state agency's regulation with the Secretary of State, the state agency is required to post the regulation on its Internet Web site in an easily marked and identifiable location. The state agency shall keep the regulation posted on its Internet Web site for at least six months from the date the regulation is filed with the Secretary of State.

2. Section 11343(c)(2): Within five (5) days of posting its regulation on its Internet Web site, the state agency shall send to OAL the Internet Web site link of each regulation that the agency posts on its Internet Web site pursuant to section 11343(c)(1).

OAL has established an email address for state agencies to send the Internet Web site link to for each regulation the agency posts. Please send the Internet Web site link for each regulation posted to OAL at postedregslink@oal.ca.gov.

NOTE ABOUT EXEMPTIONS. Posting and linking requirements do not apply to emergency regulations; regulations adopted by FPPC or Conflict of Interest regulations approved by FPPC; or regulations not subject to OAL/APA review. However, an exempt agency may choose to comply with these requirements, and OAL will post the information accordingly.

DO NOT DISCARD OR DESTROY THIS FILE

Due to its legal significance, you are required by law to preserve this rulemaking record. Government Code section 11347.3(d) requires that this record be available to the public and to the courts for possible later review. Government Code section 11347.3(e) further provides that "...no item contained in the file shall be removed, altered, or destroyed or otherwise disposed of." See also the State Records Management Act (Government Code section 14740 et seq.) and the State Administrative Manual (SAM) section 1600 et seq. regarding retention of your records.

If you decide not to keep the rulemaking records at your agency/office or at the State Records Center, you may transmit it to the State Archives with instructions that the Secretary of State shall not remove, alter, or destroy or otherwise dispose of any item contained in the file. See Government Code section 11347.3(f).

Enclosures

State of California
Office of Administrative Law

In re: **Board of Equalization**	**DECISION OF DISAPPROVAL OF REGULATORY ACTION**
Regulatory Action: **Title 18, California Code of Regulations**	**Government Code Section 11349.3**
Adopt sections: **Amend sections: 1525.4** **Repeal sections:**	**OAL Matter Number: 2016-0104-01** **OAL Matter Type: Regular (S)**

SUMMARY OF REGULATORY ACTION

In this rulemaking action, the Board of Equalization (Board) proposed to amend section 1525.4 in title 18 of the California Code of Regulations (CCR), relating to sales and use tax exemptions for certain manufacturing and research and development equipment.

On January 4, 2016, the Board submitted the above-referenced regulatory action to the Office of Administrative Law (OAL) for review. On February 17, 2016, OAL notified the Board that OAL disapproved the proposed regulations. This Decision of Disapproval of Regulatory Action explains the reasons for OAL's action.

DECISION

OAL disapproved the above-referenced rulemaking action for the following reasons:

1. The proposed action does not comply with the authority standard of Government Code section 11349.1, subdivision (a)(2);
2. The Board did not follow required procedures of the Administrative Procedure Act (APA), Department of Finance (Finance) regulations and State Administrative Manual (SAM) including:
    a. Failure to complete the Fiscal Impact portion of the STD Form 399 and obtain concurrence from Finance in compliance with Government Code sections 11346.5, subdivision (a)(6) and 11347.3, subdivision (b)(5); and SAM sections 6602, 6604 and 6615;
    b. Failure to comply with the procedures for "Major Regulations" as required by Government Code sections 1346.3, subdivision (c) and 11346.36; and sections 2000, 2002 and 2003 of title 1 of the CCR; and SAM sections 6600 and 6603.

All APA issues must be resolved prior to OAL's approval of any resubmission.

DISCUSSION

Regulations adopted by the Board must generally be adopted pursuant to the rulemaking provisions of the APA contained in chapter 3.5 of part 1 of division 3 of title 2 of the Government Code. (Gov. Code, secs. 11340 through 11361.) Any regulatory action a state agency adopts through the exercise of quasi-legislative power delegated to the agency by statute is subject to the requirements of the APA unless a statute expressly exempts or excludes the regulation from compliance with the APA. (Gov. Code, sec. 11346.) No exemption or exclusion applies to the regulatory action here under review.

Before any regulation subject to the APA may become effective, the regulation is reviewed by OAL for compliance with the procedural requirements of the APA and for compliance with the standards for administrative regulations in Government Code section 11349.1. Generally, to satisfy the APA standards, a regulation must be legally valid, supported by an adequate record, and easy to understand. In this review, OAL is limited to the rulemaking record and may not substitute its judgment for that of the rulemaking agency with regard to the substantive content of the regulation. This review is an independent check on the exercise of rulemaking powers by executive branch agencies intended to improve the quality of regulations that implement, interpret, and make specific statutory law, and to ensure that the public is provided with a meaningful opportunity to comment on regulations before they become effective.

1. AUTHORITY

A. The Authority Standard; Review of Authority

To ensure promulgation of legally valid regulations, and that agencies act within the scope of their rulemaking authority, Government Code section 11349.1 tasks OAL with reviewing proposed regulations for compliance with the Authority standard of the APA. Government Code section 11349, subdivision (b), defines "Authority" as meaning, "the provision of law which permits or obligates the agency to adopt, amend, or repeal a regulation." Section 14 of title 1 of the CCR provides in pertinent part:

(a) Sources of "Authority." "Authority" shall be presumed to exist only if an agency cites in its "authority" note proposed for printing in the California Code of Regulations:
  (1) a California constitutional or statutory provision which expressly permits or obligates the agency to adopt, amend, or repeal the regulation; or
  (2) a California constitutional or statutory provision that grants a power to the agency which impliedly permits or obligates the agency to adopt, amend, or repeal the regulation in order to achieve the purpose for which the power was granted.

(b) [...]

(c) Review of "Notes." In reviewing "notes," OAL shall use the same analytical approach employed by the California Supreme Court and the California Court of Appeal, as evidenced in published opinions of those courts.

> (1) For purposes of this analysis, an agency's interpretation of its regulatory power, as indicated by the proposed citations to "authority" or "reference" or any supporting documents contained in the rulemaking record, shall be conclusive unless:
>
> (A) *the agency's interpretation alters, amends, or enlarges the scope of power conferred upon it*; or
>
> *(B) a public comment challenges the agency's 'authority'*....[Emphasis added.]

As discussed below, OAL finds that the Board's proposed action alters, amends and/or enlarges the scope of power conferred upon the Board. Additionally, a public comment was submitted by Finance challenging the Board's rulemaking authority.[1] Therefore, the Board's interpretation of its authority is not conclusive.

B. The Board's Proposed Amendment of Section 1525.4, Title 18 of the CCR

Revenue and Taxation Code section 6377.1, subdivision (b), sets forth requirements for certain types of "qualified tangible personal property" which are eligible for the sales and use tax exemption provided by Revenue and Taxation Code section 6377.1. Section 6377.1 requires that certain tangible property have a "useful life" of one or more years in order to qualify for the exemption. Section 6377.1, subdivision (b)(10) defines "useful life" as follows:

> (10) "Useful life" for tangible personal property **that is treated 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 section. "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 purposes of this section. [Bolding added.]

In this action, to further implement Revenue and Taxation Code section 6377.1, the Board proposes to amend section 1525.4, subdivision (b)(13), contained in title 18 of the CCR. The proposed amendments to section 1525.4, reflected in underline, are as follows:

> (13)<u>(A)</u> "Useful life." Tangible personal property that the qualified person treats as having a useful life of one or more years for state income tax 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.

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1 / Finance's comment challenging the Board's authority stated "As Finance has noted previously, the Board of Equalization lacks the statutory authority to enact the proposed amendments to the sales tax exemption regulations. The statute is very clear in outlining the requirements for manufacturers to qualify for the exemption, and as the board acknowledged in the August meeting, these amendments would overstep the delegated authority."

(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 personal 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. The Proposed Amendments to Section 1525.4 Are Outside the Scope of Rulemaking Authority Granted to the Board.

In proposing to amend section 1525.4, the Board relies on Revenue and Taxation Code section 7051 for its rulemaking authority. Section 7051 provides that "[t]he board shall enforce the provision of this part and may prescribe, adopt, and enforce rules and regulations relating to the administration and enforcement of this part."[2] This section vests broad authority with the Board to adopt regulations to administer and enforce statutes and regulations relating to sales and use taxes in California, which includes authority to implement Revenue and Taxation Code section 6377.1.

Revenue and Taxation Code section 6377.1, subdivision (b)(1) specifies that deemed useful lives of certain tangible personal property are to be determined by how the property is treated for state income and franchise tax purposes. This shows the Legislature intended to look to state income and franchise tax law to govern when making this determination. The Board is charged with the collection of sales and use taxes throughout the State of California; however the Franchise Tax Board administers and enforces state income and franchise taxes. (Rev. & Tax Code, sec. 19503.) Thus, the Franchise Tax Board has the rulemaking authority to adopt regulations dealing with state income and franchise tax law.

The Board first adopted regulation section 1525.4 in 2014. At that time, section 1525.4, subdivision (b)(13) simply stated: "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." In the current action, however, the Board proposes to amend section 1525.4 to specify certain situations relating to personal property that will <u>deem</u> the property as having a useful life of one or more years <u>for state income or franchise tax purposes</u>. As noted above, section 7051 vests the Board with the authority to adopt regulations to administer and enforce sales and use taxes; however, the Franchise Tax Board has the authority to adopt regulations that deal with state income and franchise tax laws. Thus, the Board's attempt to amend section 1525.4 to specify how tangible property is treated for state income or franchise tax purposes is outside the rulemaking authority granted to the Board by Revenue and Taxation Code section 7051.

D. The Proposed Amendment of Section 1525.4 Alters and/or Amends the Scope of Revenue and Taxation Code Section 6377.1.

Government Code section 11342.1 states, in part, "Each regulation adopted, to be effective, *shall be within the scope of authority conferred* and in accordance with standards prescribed by other provisions of law." (Emphasis added.) Government Code section 11342.2 provides that "[w]henever by the express or implied terms of any statute a state agency has authority to adopt

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2 / The language "this part" as used in section 7051 refers to Part 1, titled "Sales and Use Taxes" of Division 2 of the Revenue and Taxation Code. The Board is also charged with enforcing other taxes in California, such as property taxation (Gov. Code, sec. 15606.) and other special taxes, such as excise taxes on tobacco and alcohol. (Rev. & Tax Code, secs. 30451 and 32451.)

regulations to implement, interpret, make specific or otherwise carry out the provision of the statute, no regulation adopted is valid or effective unless consistent and not in conflict with the statute and reasonably necessary to effectuate the purpose of the statute." "Administrative regulations that alter or amend the statute or enlarge or impair its scope are void." (*Pulaski v. California Occupational Safety & Health Standards Bd.* (1999) 75 Cal.App.4th 1315, 1332 [hereinafter "*Pulaski*"].)

In *Pulaski*, the Court reviewed regulations adopted by the Department of Industrial Relations' Occupational Safety and Health Standards Board (Standards Board) to address repetitive motion injuries in the workplace. (*Pulaski, supra*, 75 Cal.App.4th at pp. 1325-1326.) The Standards Board's regulations implemented Labor Code section 6357, which stated in part that "the [Standards Board] shall adopt standards for ergonomics in the workplace designed to minimize the instances of injury from repetitive motion." (*Id.* at 1325.) The Standards Board also had broad rulemaking authority pursuant to Labor Code section 6307, granting the Standards Board "the power, jurisdiction, and supervision over every employment and place of employment in this state, which is necessary to adequately enforce and administer all laws and lawful standards...requiring such employment and place of employment to be safe...." (*Id.* at 1339.)

In adopting regulations containing ergonomic standards, the Standards Board included a small business exemption, which was challenged by labor groups. In striking down the small business exemption, the Court found that because the Standards Board is required to ensure that all workplaces and places of employment were safe (Lab. Code, sec. 6307.), the small business exemption for ergonomic standards (Lab. Code, sec. 6357.) was inconsistent with the statute and therefore beyond the Standards Board's authority. (*Pulaski*, *supra,* 75 Cal.App.4th at pp. 1340-1341.) As the Court noted, "Because the exemption is inconsistent with the mandate of section 6357, it was jurisdictionally infirm. There is no agency discretion to promulgate a regulation which is inconsistent with the governing statute. [citation omitted.] Accordingly, we need not concern ourselves with whether the exemption is wise or reasonable as a matter of policy. If it transgresses the statutory power of the agency, it is invalid. " (*Pulaski*, at 1341 [Internal citations and quotes omitted.])

In this action, the Board has similarly attempted to adopt language that is inconsistent with the mandate set forth in the statute and therefore the Board has acted beyond its rulemaking authority. Revenue and Taxation Code section 6377.1, subdivision (b)(10), includes mandatory language for the treatment of tangible personal property requiring that the property <u>shall be deemed</u> to have a useful life for purposes of section 6377.1 that is the same as how the property was treated for state income or franchise tax purposes. Contrary to the language in section 6377.1, the proposed amendments would "deem" certain tangible personal property to have a useful life of one or more years if it meets any of the Board's criteria regardless of how the property is actually treated for state income and franchise tax purposes.

While Revenue and Taxation Code section 7051 vests the Board with broad rulemaking authority relating to sales and use taxes, the language in Section 6377.1, subdivision (b)(10), specifies deemed useful lives of property based on <u>how the property is treated for state income and franchise tax purposes</u>. This provision shows the Legislature's intent to look to state income and franchise tax law when making this determination. Thus, similar to the court in *Pulaski*,

because proposed amendments to section 1525.4 alter and amend the scope of Revenue and Taxation Code section 6377.1, subdivision (b)(10), the amendments transgress the statutory power of the Board. (Gov. Code, secs. 11342.1 and 11342.2; *Pulaski*, *supra*, 75 Cal.App.4th at p. at 1341.)

For these reasons, OAL finds that the Board's proposed amendments to section 1525.4 does not comply with the authority standard.

2. INCORRECT PROCEDURE

A. Fiscal Impact Statement and Department of Finance Concurrence

Government Code section 11346.5, subdivision (a)(6), requires that the notice of proposed adoption, amendment, or repeal of a regulation include "An estimate, prepared in accordance with the instructions adopted by the Department of Finance, of the cost or savings to any state agency, the cost to any local agency or school district that is required to be reimbursed under Part 7 (commencing with Section 17500) of Division 4, other nondiscretionary cost or saving imposed on local agencies, and the cost or savings in federal funding to the state."

Government Code section 11357 requires the Department of Finance (Finance) to adopt instructions for inclusion in the SAM for determining and making estimates for fiscal or economic impacts required by Government Code sections 11346.2, 11346.3 and 11346.5. Government Code section 11357, subdivision (c), provides "[t]he Department of Finance may review an estimate prepared pursuant to this section for content, including but not limited to, the data and assumptions used in its preparation." Instructions adopted by Finance for making fiscal and economic estimates by state agencies are included in the SAM. (SAM, secs. 6600-6615.)

In defining "revenues", SAM section 6602 provides that "[a]ny changes in the amounts of operating income received by state and local agencies as a result of an executive regulation must be identified. **In this context, 'revenue' includes taxes**, state and/or federal assistance, fees, licenses, and so forth." (Bolding added.)

SAM section 6604 states:

> A state agency that adopts, amends, or repeals a routine regulation or emergency regulation must make a local mandate determination and an estimate of fiscal impact resulting from the 'regulation' on the following:
>
> State Agencies
>
> ...
>
> 3. Any other impacts such as revenue changes.

SAM section 6615 provides: "A state agency is not required in all instances to obtain the concurrence of the [Finance] in its estimate of the fiscal impact of its proposed regulation on governmental agencies. **Such concurrence is required when the adoption, amendment, or repeal of a regulation results in** local agency costs or savings, in state agency costs or savings,

or in other non-discretionary instances such as local/state revenue increases or decreases which must be depicted on the STD as follows: A.1 Reimbursable Local Costs, A.2 – Non-Reimbursable Local Costs, A.3 – Local Savings, A.6 – Other, B.1 – State Costs, B.2. – State Savings, **B.4 – Other.**" (Bolding added.)

Regulation section 1525.4 was first adopted by the Board in 2014 to implement Revenue and Taxation Code section 6377.1. At the time section 6377.1 was enacted, Finance estimated that the amount of annual purchases/sales in the 2014-2015 fiscal year that could benefit from this exemption was $15 billion. If fully utilized, this exemption would result in approximately $486 million in sales and use tax savings for qualified persons as defined the statute. (Sen. Rules Com., Off. of Sen. Floor Analyses, 3d reading analysis of Assem. Bill No. 93 (2013-2014 Reg. Sess.) as amended June 24, 2013.)

In this action, the Board proposes to amend section 1525.4, subdivision (b)(13). The proposed amendments add criteria for determining the "useful life" of tangible personal property for purposes of determining whether the sales and use tax exemption applies. The justification for the proposed amendments is that there is confusion on the part of taxpayers as to what purchases qualify for the exemption and therefore the exemption is being underutilized. (Initial Statement of Reasons (ISR), pp. 5-6 & 7-8.) The ISR states "that 'for the first year, the [ ] exemption usage was anticipated to be [based on] approximately $15 billion [of expenditures]. However, based upon returns to date, we have [only] seen approximately $3 billion of usage' which may be due to the perceived ambiguities in the statute." (ISR, p. 8.) The ISR further states that the proposed amendments are intended "to ensure that the [ ] exemption provided by Revenue and Taxation Code section 6377.1 is utilized as originally intended by the Legislature". (ISR, p. 8.)

For the Fiscal Impact Statement portion of the STD Form 399, regarding fiscal impact on state agencies, the Board checked box B.3., indicating "no fiscal impact exists. This regulation does not affect any State agency or program." (STD Form 399, p.5.)

During the 45-day public comment period, Finance submitted a comment to the Board. With regard to the fiscal impact of the Board's proposed amendments to section 1525.4, Finance's comment states:

> The argument that these amendments would have no revenue impact because they 'would be consistent with the implementing statute' is insufficient. Even when legislation contemplates increased expenditures or revenue losses (tax expenditures), they must be reflected in the STD 399. In addition, to the extent these regulations are further revised to resolve a statutory ambiguity to increase utilization of the exemption, the increase in the exemption over what would be expected under the current regulations would result in a revenue loss. Therefore, this revenue loss results in a fiscal impact. As the amendments would trigger a fiscal impact from the additional exemptions, a signature is also required from Finance on the STD 399 before these regulations can be adopted. If OAL chooses to allow the board to proceed with these regulations, that STD 399 must be forwarded to Finance for approval.

(Nov. 10, 2015 Letter from Kristin Shelton, Program Budget Manager, Department of Finance.)

In response to Finance's comment, the Board maintained the position that the proposed amendments do not have any fiscal impact because the amount of any revenue loss does not come from the proposed amendment, but from Revenue and Taxation Code section 6377.1 and from the intent of the Legislature that this exemption be fully utilized in the amounts originally estimated by Finance. (FSR, pp. 3-5.)

Pursuant to SAM section 6615, if the Board's proposed amendments increase or decrease local/state revenue, then the Board must check box "B.4 – Other" in the Fiscal Impact portion of the STD Form 399 and must also obtain Finance concurrence. As noted above, underutilization of the exemption has resulted in approximately $3 billion in sales and use tax exemptions out of the intended $15 billion. The Board's stated purpose of the current proposed amendments is to increase utilization of this exemption, which, if successful could result in as much as a $364.5 million decrease in revenue from sales and use taxes to the state. Therefore, the Board was required to check box "B.4 – Other" in the Fiscal Impact Statement of the Form 399 to reflect this decrease in revenue to the state and to obtain Finance concurrence. (SAM, sec. 6615.)

In light of the foregoing, the Board failed to follow procedures to properly complete the STD Form 399 and obtain the required signature from Finance on the STD Form 399 as mandated by the Government Code and SAM.

B. <u>Major Regulations</u>

Government Code section 11346.3, subdivision (c) requires "[e]ach state agency proposing to adopt, amend, or repeal a major regulation on or after November 1, 2013, shall prepare a standardized regulatory impact analysis in the manner prescribed by the Department of Finance pursuant to Section 11346.36." Subdivision (c) goes on to specify economic impacts that the standard regulatory impact analysis (SRIA) "shall address".

Government Code section 11346.3, subdivision (f) requires "[e]ach state agency … that has prepared a standardized regulatory impact analysis pursuant to subdivision (c), shall submit that analysis to the Department of Finance upon completion." Subdivision (f) goes on to require Finance to provide comments to the rulemaking agency on the agency's analysis and requires the agency to respond to Finance's comments.

Government Code section 11346.36 requires Finance to adopt regulations for conducting the SRIA as required by Government Code section 11346.3, subdivision (c). Section 11346.36, subdivision (e), provides that the SRIA "shall be included in the initial statement of reasons for the regulation as provided in subdivision (b) of Section 11346.2."

Government Code section 11357, subdivision (c), provides "The Department of Finance may review an estimate prepared pursuant to this section for content, including but not limited to, the data and assumptions used in its preparation."

Title 1, CCR section 2000, defines a "major regulation" as "any proposed rulemaking action adopting, amending or repealing a regulation subject to review by OAL that will have an economic impact on California business enterprises and individuals in an amount exceeding fifty million dollars ($50,000,000) in any 12-month period between the date the major regulation is estimated to be fully implemented (as estimated by the agency), computed without regard to any offsetting benefits or costs that might result directly or indirectly from that adoption, amendment or repeal."[3]

Section 2000 defines "economic impact" for purposes of determining whether a regulation is a "major regulation" as "all costs or benefits (direct, indirect and induced) of the proposed major regulation on business enterprises and individuals located in or doing business in California."

The stated purpose of the proposed amendments is to increase the current utilization of approximately $3 billion to closer to the $15 billion as originally estimated when Revenue and Taxation Code section 6377.1 was enacted by the Legislature. (ISR, pp. 5-6 & 7-8.) If successful, the proposed amendments would result in a revenue loss to the state of approximately a $364.5 million. This revenue loss to the state would be a $364.5 million economic benefit to businesses and other entities otherwise subject to the tax. This amount exceeds the $50 million threshold invoking the major regulation requirements set forth above.

Finance's comment to the Board states:

> ...[T]he proposed regulations meet the $50 million economic impact threshold for major regulations. As a result, a SRIA is required before the regulations can be adopted or the rulemaking process finalized pursuant to the California Code of Regulations. The sales tax exemption amendments have the stated purpose of encouraging manufacturers to purchase additional equipment without paying sales tax. While the level of additional exemptions claimed under the proposed amendments is not clear, the board notes that in the current year the amount of qualified expenditures claims was $12 billion less than was anticipated when the legislation was adopted. If even a small fraction of this $12 billion gap is closed by these amendments, the threshold of $50 million of economic activity in one twelve-month period would be exceeded. (Nov. 10, 2015 Letter from Kristin Shelton, Program Budget Manager, Department of Finance.)

In the Final Statement of Reasons (FSR), the Board responds to Finance's comment, stating that the proposed regulations have no economic impact because "they are intended to ensure that the partial exemption is utilized at the level the Legislature intended, and will not result in a loss of revenue in excess of the amount the Governor and the Legislature have allocated." (FSR, p. 4.) The Board further responds that the "proposed amendments are merely a clarification 'that does not increase costs.'" (FSR, p. 5.)

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3 / "Major Regulation" is also defined in Government Code section 11342.548.

Given that the proposed regulations would result in an economic benefit of more than $50 million, and based on the findings by Finance, the requirements for the adoption of a major regulation must be complied with in accordance with the APA and Finance regulations and instructions. The Board has failed to comply with these requirements, therefore, OAL cannot approve this proposed rulemaking.

CONCLUSION

For the reasons set forth above, OAL has disapproved this regulatory action. If you have any questions, please contact me at (916) 323-8916.

Date: February 24, 2016

Kevin D. Hull
Senior Attorney

FOR: Debra M. Cornez
Director

Original: Cynthia Bridges
Copy: Richard Bennion

STATE OF CALIFORNIA—OFFICE OF ADMINISTRATIVE LAW

REGULAR

NOTICE PUBLICATION/REGULATIONS SUBMISSION

(See instructions on reverse)

ORIGINAL

For use by Secretary of State only

STD. 400 (REV. 01-2013)

OAL FILE NUMBERS	NOTICE FILE NUMBER	REGULATORY ACTION NUMBER	EMERGENCY NUMBER
	Z-2015-0915-10	2016-0104-01S	

For use by Office of Administrative Law (OAL) only

DISAPPROVED

2016 JAN -4 P 1:51

OFFICE OF ADMINISTRATIVE LAW

NOTICE

REGULATIONS

AGENCY WITH RULEMAKING AUTHORITY
State Board of Equalization

AGENCY FILE NUMBER (If any)

A. PUBLICATION OF NOTICE (Complete for publication in Notice Register)

1. SUBJECT OF NOTICE	TITLE(S)	FIRST SECTION AFFECTED	2. REQUESTED PUBLICATION DATE

3. NOTICE TYPE	4. AGENCY CONTACT PERSON	TELEPHONE NUMBER	FAX NUMBER (Optional)
☐ Notice re Proposed Regulatory Action ☐ Other			

OAL USE ONLY	ACTION ON PROPOSED NOTICE	NOTICE REGISTER NUMBER	PUBLICATION DATE
	☐ Approved as Submitted ☐ Approved as Modified ☐ Disapproved/ Withdrawn	2015, 39-Z	9/25/2015

B. SUBMISSION OF REGULATIONS (Complete when submitting regulations)

1a. SUBJECT OF REGULATION(S)
Manufacturing and Research & Development Equipment

1b. ALL PREVIOUS RELATED OAL REGULATORY ACTION NUMBER(S)

2. SPECIFY CALIFORNIA CODE OF REGULATIONS TITLE(S) AND SECTION(S) **(Including title 26, if toxics related)**

SECTION(S) AFFECTED (List all section number(s) individually. Attach additional sheet if needed.)

ADOPT

AMEND
1525.4

REPEAL

TITLE(S)
18

3. TYPE OF FILING

- ☒ Regular Rulemaking (Gov. Code §11346)
- ☐ Resubmittal of disapproved or withdrawn nonemergency filing (Gov. Code §§11349.3, 11349.4)
- ☐ Emergency (Gov. Code, §11346.1(b))
- ☐ Certificate of Compliance: The agency officer named below certifies that this agency complied with the provisions of Gov. Code §§11346.2-11347.3 either before the emergency regulation was adopted or within the time period required by statute.
- ☐ Resubmittal of disapproved or withdrawn emergency filing (Gov. Code, §11346.1)
- ☐ Emergency Readopt (Gov. Code, §11346.1(h))
- ☐ File & Print
- ☐ Other (Specify) _____
- ☐ Changes Without Regulatory Effect (Cal. Code Regs., title 1, §100)
- ☐ Print Only

4. ALL BEGINNING AND ENDING DATES OF AVAILABILITY OF MODIFIED REGULATIONS AND/OR MATERIAL ADDED TO THE RULEMAKING FILE (Cal. Code Regs. title 1, §44 and Gov. Code §11347.1)

5. EFFECTIVE DATE OF CHANGES (Gov. Code, §§ 11343.4, 11346.1(d); Cal. Code Regs., title 1, §100)

- ☒ Effective January 1, April 1, July 1, or October 1 (Gov. Code §11343.4(a))
- ☐ Effective on filing with Secretary of State
- ☐ §100 Changes Without Regulatory Effect
- ☐ Effective other (Specify) _____

6. CHECK IF THESE REGULATIONS REQUIRE NOTICE TO, OR REVIEW, CONSULTATION, APPROVAL OR CONCURRENCE BY, ANOTHER AGENCY OR ENTITY

- ☐ Department of Finance (Form STD. 399) (SAM §6660)
- ☐ Fair Political Practices Commission
- ☐ State Fire Marshal
- ☐ Other (Specify) _____

7. CONTACT PERSON	TELEPHONE NUMBER	FAX NUMBER (Optional)	E-MAIL ADDRESS (Optional)
Richard E. Bennion	(916) 445-2130	(916) 324-3984	rbennion@boe.ca.gov

8. **I certify that the attached copy of the regulation(s) is a true and correct copy of the regulation(s) identified on this form, that the information specified on this form is true and correct, and that I am the head of the agency taking this action, or a designee of the head of the agency, and am authorized to make this certification.**

For use by Office of Administrative Law (OAL) only

DISAPPROVED

SIGNATURE OF AGENCY HEAD OR DESIGNEE
Joann Richmond

DATE
December 30, 2015

TYPED NAME AND TITLE OF SIGNATORY
Joann Richmond, Chief, Board Proceedings Division

Final Text of Proposed Amendments to

California Code of Regulations, Title 18, Section 1525.4,

Manufacturing and Research & Development Equipment

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)(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 personal 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.

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.

AGENCY CONTACT PERSONS

Inquiries concerning the substance of the proposed regulatory action may be directed to the agency representative Dr. Dongmin Luo, P.E., Manager of the Air Quality and Climate Science Section, at (916) 324–8496 or Mr. Winston Potts (designated back–up contact), P.E., Air Resources Engineer, Air Quality and Climate Science Section, (916) 323–2537.

AVAILABILITY OF DOCUMENTS

ARB staff has prepared a Staff Report: Initial Statement of Reasons (ISOR) for the proposed regulatory action, which includes a summary of the economic and environmental impacts of the proposal. The report is entitled: "Proposed Amendments to the Regulation for Small Containers of Automotive Refrigerant."

Copies of the ISOR and the full text of the proposed regulatory language, in underline and strikeout format to allow for comparison with the existing regulations, may be accessed on ARB's website listed below, or may be obtained from the Public Information Office, Air Resources Board, 1001 I Street, Visitors and Environmental Services Center, First Floor, Sacramento, California, 95814, (916) 322–2990, on March 1, 2016.

Further, the agency representative to whom nonsubstantive inquiries concerning the proposed administrative action may be directed is Trini Balcazar, Regulations Coordinator, (916) 445–9564. The Board staff has compiled a record for this rulemaking action, which includes all the information upon which the proposal is based. This material is available for inspection upon request to the Regulations Coordinator.

HEARING PROCEDURES

The public hearing will be conducted in accordance with the California Administrative Procedure Act, Government Code, title 2, division 3, part 1, chapter 3.5 (commencing with section 11340).

Following the public hearing, the Board may adopt the regulatory language as originally proposed, or with non–substantial or grammatical modifications. The Board may also adopt the proposed regulatory language with other modifications if the text as modified is sufficiently related to the originally proposed text that the public was adequately placed on notice and that the regulatory language as modified could result from the proposed regulatory action; in such event, the full regulatory text, with the modifications clearly indicated, will be made available to the public, for written comment, at least 15–days before it is adopted.

The public may request a copy of the modified regulatory text from ARB's Public Information Office, Air Resources Board, 1001 I Street, Visitors and Environmental Services Center, First Floor, Sacramento, California, 95814, (916) 322–2990.

FINAL STATEMENT OF REASONS AVAILABILITY

Upon its completion, the Final Statement of Reasons (FSOR) will be available and copies may be requested from the agency contact persons in this notice, or may be accessed on ARB's website listed below.

INTERNET ACCESS

This notice, the ISOR and all subsequent regulatory documents, including the FSOR, when completed, are available on ARB's website for this rulemaking at http://www.arb.ca.gov/regact/2016/smallcans2016/smallcans2016.html.

DISAPPROVAL DECISION

DECISION OF DISAPPROVAL OF REGULATORY ACTION

Printed below is the summary of an Office of Administrative Law disapproval decision. The full text of the disapproval decision is available at www.oal.ca.gov under the "Publications" tab. You may also request a copy of a decision by contacting the Office of Administrative Law, 300 Capitol Mall, Suite 1250, Sacramento, CA 95814–4339, (916) 323–6225 — FAX (916) 323–6826. Please request by OAL file number.

BOARD OF EQUALIZATION

State of California
Office of Administrative Law

In re:
Board of Equalization
Regulatory Action:
Title 18, California Code of Regulations
Amend sections: 1525.4
DECISION OF DISAPPROVAL OF REGULATORY ACTION
Government Code Section 11349.3
OAL Matter Number: 2016–0104–01

OAL Matter Type: Regular (S)

SUMMARY OF REGULATORY ACTION

In this rulemaking action, the Board of Equalization (Board) proposed to amend section 1525.4 in title 18 of the California Code of Regulations (CCR), relating to sales and use tax exemptions for certain manufacturing and research and development equipment.

On January 4, 2016, the Board submitted the above–referenced regulatory action to the Office of Administrative Law (OAL) for review. On February 17, 2016, OAL notified the Board that OAL disapproved the proposed regulations. This Decision of Disapproval of Regulatory Action explains the reasons for OAL's action.

DECISION

OAL disapproved the above–referenced rulemaking action for the following reasons:

1. The proposed action does not comply with the authority standard of Government Code section 11349.1, subdivision (a)(2);
2. The Board did not follow required procedures of the Administrative Procedure Act (APA), Department of Finance (Finance) regulations and State Administrative Manual (SAM) including:
   a. Failure to complete the Fiscal Impact portion of the STD Form 399 and obtain concurrence from Finance in compliance with Government Code sections 11346.5, subdivision (a)(6) and 11347.3, subdivision (b)(5); and SAM sections 6602, 6604 and 6615;
   b. Failure to comply with the procedures for "Major Regulations" as required by Government Code sections 1346.3, subdivision (c) and 11346.36; and sections 2000, 2002 and 2003 of title 1 of the CCR; and SAM sections 6600 and 6603.

All APA issues must be resolved prior to OAL's approval of any resubmission.

CONCLUSION

For the reasons set forth above, OAL has disapproved this regulatory action. If you have any questions, please contact me at (916) 323–8916.

Date: February 24, 2016

Kevin D. Hull
Senior Attorney

FOR: Debra M. Cornez
Director

Original: Cynthia Bridges
Copy: Richard Bennion

SUMMARY OF REGULATORY ACTIONS

REGULATIONS FILED WITH SECRETARY OF STATE

This Summary of Regulatory Actions lists regulations filed with the Secretary of State on the dates indicated. Copies of the regulations may be obtained by contacting the agency or from the Secretary of State, Archives, 1020 O Street, Sacramento, CA 95814, (916) 653–7715. Please have the agency name and the date filed (see below) when making a request.

File# 2016–0128–02
BOARD OF REGISTERED NURSING
Intervention Program Guidelines

This change without regulatory effect filing by the Board of Registered Nursing amends three sections in title 16 of the California Code of Regulations by changing the term "diversion" to "intervention" pursuant to a statutory change.

Title 16
AMEND: 1446, 1447, 1447.1
Filed 02/24/2016
Agency Contact: Ronnie Whitaker (916) 574–8257

File# 2016–0112–01
CALIFORNIA ARCHITECTS BOARD
Application for Eligibility Evaluation (AEE)

In this regulatory action, the Board amends sections 109 and 111 of Title 16 of the California Code of Regulations to update Form 19C–1, Application for Eligibility Evaluations. The most notable change to the form is that it now includes an inquiry on whether the applicant served as an active duty member of the U.S. Armed Forces and whether he or she was honorably discharged. This modification to the form was made to comply with Business and Professions Code section 115.4.

Title 16
AMEND: 109, 111
Filed 02/23/2016
Effective 04/01/2016
Agency Contact: Timothy Rodda (916) 575–7217

Rulemaking File Index

Title 18. Public Revenue

Sales and Use Tax

Regulation 1525.4,

Manufacturing and Research & Development Equipment.

1. Final Statement of Reasons
2. Updated Informative Digest
3. Chief Counsel Matters, August 25, 2015
    - Chief Counsel memo dated August 3, 2015
    - Petition from Cal Tax dated July 21, 2015
    - Al Tax Attachment – Proposed Amendments to Regulation 1525.4
    - Formal Issue Paper 14-001
4. Reporter's Transcript Item J1, August 25, 2015
5. Estimate of Cost or Savings, September 17, 2015
6. Economic and Fiscal Impact Statements, September 15, 2015
7. Notice of Publications
    - Form 400 and Notice, Publication Date July 17, 2015
    - Email sent to Interested Parties, July 17, 2015
    - CA Regulatory Notice Register 2015, Volume No. 39-Z
8. Notice to Interested Parties, September 25, 2015

    The following items are exhibited:

    - Notice of Hearing
    - Initial Statement of Reasons
    - Proposed Text of Regulations 1525.4
    - Regulation History
9. Statement of Compliance
10. Public Comment, Kristin Shelton, November 10, 2015
11. Reporter's Transcript, Item F1, November 17, 2015
12. Draft Minutes, November 17, 2015, and Exhibits
    - Notice of Proposed Regulatory Action
    - Initial Statement of Reasons
    - Proposed Text of Regulations 1525.4
    - Regulation History

VERIFICATION

I, Richard E. Bennion, Regulations Coordinator of the State Board of Equalization, state that the rulemaking file of which the contents as listed in the index is complete, and that the record was closed on December 24, 2015 and that the attached copy is complete.

I declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct.

December 24, 2015

Richard E. Bennion
Regulations Coordinator
State Board of Equalization

Final Statement of Reasons for Proposed Amendments to California Code of Regulations, Title 18, Section 1525.4, *Manufacturing and Research & Development Equipment*

UPDATE OF INFORMATION IN THE INITIAL STATEMENT OF REASONS

On November 17, 2015, the State Board of Equalization (Board) held a public hearing regarding the proposed amendments to California Code of Regulations, title 18, section (Regulation) 1525.4, *Manufacturing and Research & Development Equipment*. The proposed amendments further implement, interpret, and makes specific the "useful life" provisions used in Revenue and Taxation Code (RTC) section 6377.1, which provides a 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, by adding clarifying provisions to the regulation expressly permitting taxpayers to substantiate the useful life of otherwise qualified tangible personal property using a warranty, service contract, or industry practice.

As relevant here, the initial statement of reasons for the proposed amendments explains that:

> Section 1 of [Assembly Bill No. (AB) 93 (Stats. 2013, ch. 69, effective July 11, 2013)] 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. Also, as explained above, the Legislature intended for the partial exemption provided by RTC section 6377.1 to be fully utilized and, to ensure such utilization, RTC section 6377.1, subdivision (g), required the Department of Finance to estimate the total dollar amount of exemptions that will be taken for each calendar year the partial exemption will be in effect and requires the Board to annually report the total dollar amount of exemptions taken for the immediately preceding calendar year, compare the total dollar amount of those exemptions to the Department of Finance's estimate for that same year, and identify options for increasing exemptions taken so as to meet the Department of Finance's estimates when necessary. And, the Board anticipates that RTC section 6377.1 will continue to have an economic impact on business and state revenue as . . . the Legislature intended.
>
> [Also], RTC section 6377.1, subdivision (b)(7), requires that tangible personal property have a useful life of one or more years in order for that property to be "qualified tangible personal property" for purposes of the partial exemption, and RTC section 6377.1, subdivision (b)(10), provides that: "'Useful life' for tangible personal property that is treated 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 section. '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 purposes of this section."

The Board has determined that there is an issue because RTC section 6377.1 does not specify whether a qualified person who currently deducts the entire cost of otherwise qualified tangible personal property that actually has a useful life of one or more years is "treating" such property as having a useful life of less than one year or a useful life of one or more years for state franchise and income tax purposes. RTC section 6377.1 does not expressly state that its "deemed" provisions are the exclusive means by which a qualified person may substantiate that otherwise qualified tangible personal property has a useful life of one or more years for purposes of the partial exemption. RTC section 6377.1 does not provide other reasonable means to establish that otherwise qualified tangible personal property has a useful life of one or more years. And, the lack of specificity creates an ambiguity as to whether it is permissible to use other reasonable methods to substantiate the useful life of otherwise qualified tangible personal property under the statute. The Board also determined that the amendments to Regulation 1525.4 requested in CalTax's petition . . . are reasonably necessary for the specific purpose of addressing the issue created by the ambiguity in the statute by adding clarifying provisions to the regulation expressly permitting taxpayers to substantiate the useful life of otherwise qualified tangible personal property using other reasonable means, including a warranty, service contract, or industry practice.

The Board anticipates that the proposed amendments will benefit qualified persons who deduct, rather than capitalize, the cost of otherwise qualified tangible personal property on their state franchise and income tax returns by clarifying that they may substantiate that such property satisfies the "useful life" requirements for the partial exemption provided by RTC section 6377.1 using a warranty, service contract, or industry practice. The Board anticipates that the proposed amendments will benefit all taxpayers by promoting fairness and helping ensure that similarly situated taxpayers, such as Taxpayer A and Taxpayer B referred to in CalTax's petition, do not receive disparate treatment. The Board also anticipates that the proposed amendments will generally benefit the people of the State of California by helping ensure that the partial exemption provided by RTC section 6377.1 is utilized[1] as originally anticipated by the Legislature and that the statute increases manufacturing and manufacturing jobs in California as the Legislature intended.

The Board has also determined that the proposed amendments to Regulation 1525.4 are fully consistent with current law, including RTC section 6377.1, subject to OAL approval, and there is nothing in the proposed amendments that

[1] The initial statement of reasons explains earlier that for the first year, the partial exemption usage was anticipated to be based on approximately $15 billion of expenditures. However, based upon returns to date, Board staff has only seen approximately $3 billion of usage, which may be due to the perceived ambiguities in the statute.

> would significantly change how the Legislature intended for individuals and businesses to behave in response to RTC section 6377.1. Therefore, the Board estimates that the proposed amendments, themselves, 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 amendments to Regulation 1525.4 are 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 amendments 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.

Prior to the public hearing regarding the proposed amendments to Regulation 1525.4, the Board received a letter dated November 10, 2015, from Ms. Kristin Shelton, Program Budget Manager for the Department of Finance. The letter stated that the Board "lacks the statutory authority to enact the proposed amendments" because Revenue and Taxation Code (RTC) section 6377.1 is "very clear" and "the amendments would overstep the [Board's] delegated authority" to implement, interpret, and make specific the statute. The letter stated that the proposed amendments "would result in a revenue loss," the "revenue loss results in a fiscal impact," and, as a result, the Board's "STD. 399 must be revised to include the fiscal impact," and the Board must obtain "a signature from Finance on a STD. 399 [showing the fiscal impact] before the [amendments] can be adopted." The letter stated that the proposed amendments "meet the $50 million economic impact threshold for major regulations" and the Board would "need to complete a Standardized Regulatory Impact [Analysis] (SRIA) to meet the major regulations requirements." (Gov. Code, § 11346.3; Cal. Code Regs., tit. 1, § 2002 and 2003.) The letter also encouraged the Board to "withdraw" the proposed amendments.

At the commencement of the November 17, 2015, public hearing, Board staff noted that the Board received Ms. Shelton's letter. Board staff explained that Ms. Shelton's letter contained the Department of Finance's opinions that the Board "overstepped its delegated authority" to implement, interpret, and make specific RTC section 6377.1, the Board was required to prepare an STD form 399 showing that "there is a significant fiscal impact" from the proposed amendments to Regulation 1525.4 and obtain the Department of Finances "concurrence in the assessment" of that fiscal impact (per State Administrative Manual section 6614), and that the proposed amendments "result in a major regulation" because they "would have an impact exceeding $50 million in a 12-month period." Staff also informed the Board that the Office of Administrative Law (OAL) may disapprove the Board's adoption of the proposed amendments if OAL agrees with Ms. Shelton's letter and concludes that the adoption of the proposed amendments exceeds the Board's rulemaking authority, or that the Board failed to substantially comply with the Administrative Procedure Act's requirements to determine the fiscal impact of the proposed regulatory action and prepare an economic impact assessment or SRIA for the proposed amendments. In addition, staff advised the Board that it could decide not to proceed with the proposed amendments if the Board had concerns about the comments in Ms. Shelton's letter, but that the Board could not procedurally withdraw the proposed amendments from OAL's consideration because they had not been submitted to OAL for review yet.

Also, Ms. Therese Twomey, Fiscal Policy Director for the California Taxpayers Association (CalTax), appeared at the public hearing, and after staff's opening remarks Ms. Twomey expressed CalTax's opinions that:

- The "Board is fully within its vested authority to make regulatory changes to provide taxpayer guidance on this issue" when "taxpayers are asking for an interpretation on an ambiguity" to resolve "an inherent conflict of two provisions in the statute itself" to "allow taxpayers and the [Board] to administer the statute the way it was intended by the Legislature";
- The Department of Finance "estimate was that taxpayers would be allowed to use $486 million of this exemption," but, "[t]o date, the utilization" is only "25 percent," and the proposed amendments "provide taxpayers with the guidance necessary in order to give them comfort to use the exemption" as estimated; and
- The proposed amendments do not result in an economic impact or "cost increase."

In response, Board Member George Runner agreed with Ms. Twomey that the Board had the authority to adopt the proposed amendments and that the proposed amendments would not result in an economic impact because they would not result in a loss of "new" or "additional" revenue beyond the amount estimated to be lost as a result of the enactment of the statute. He also said he thought the amendments were important and that he supported moving forward with their adoption. However, in response to Board Member Runner's comments, Deputy State Controller Yvette Stowers said that, for the record, she objects to the Board moving forward.

Next, Board Member Diane Harkey asked Ms. Twomey if CalTax thought it would make it more difficult to seek a legislative fix to the ambiguity in the statute if the Board adopted the proposed amendments, but they were not approved by OAL. Ms. Twomey responded that she "didn't believe so" and she said that she thought the Board's support of the proposed amendments "would add to and help our legislative process."

Next, Board Chairman Jerome Horton said that he agreed that the Board "has the authority" to adopt the proposed amendments. Chairman Horton indicated that he could see how the Department of Finance might think that "increasing the usage [of the partial exemption] may result in this additional cost factor that the Department of Finance has put forward." However, Chairman Horton did not agree with the Department of Finance that the proposed amendments have an economic impact after discussing the utilization of the partial exemption with Board staff, Board Member Runner, and Ms. Twomey. Instead, he appeared to agree with Board Member Runner and Ms. Twomey that the proposed amendments will not have an economic impact and will not constitute a major regulation because they are intended to ensure that the partial exemption is utilized at the level the Legislature intended, and will not result in a loss of revenue in excess of the amount the "Governor and the Legislature have allocated." Chairman Horton also expressed concern about voting to adopt the proposed amendments, at this time. He called the Department of Finance's comments a "poison pill" and he indicated that he anticipated that OAL would disapprove the proposed amendments based upon the Department of Finance's comments.

Finally, Board Member Fiona Ma said that there is confusion regarding the statute, which is limiting the utilization of the partial exemption. She said the Board does have authority to interpret the statute to assist taxpayers in determining whether they qualify for the partial exemption. And, the proposed amendments are merely a clarification "that does not increase costs."

At the conclusion of the public hearing, Board Members Harkey, Runner, and Ma voted to adopt the proposed amendments to Regulation 1525.4 without making any changes. The Board determined that it has authority, pursuant to RTC section 7051, to adopt the proposed amendments to further implement, interpret, and makes specific the "useful life" provisions used in RTC section 6377.1, that the proposed amendments do not result in the economic impact referred to in Ms. Shelton's letter, and that the proposed amendments are not a major regulation as stated in Ms. Shelton's letter.

The Board's responses to Ms. Shelton's letter (discussed above) and the Board Members', Board staff's, and Ms. Twomey's comments made during the public hearing provide further support for the Board's adoption of the proposed amendments. However, the factual basis, specific purpose, and necessity for, the problem to be addressed by, and the anticipated benefits from the adoption of the proposed amendments to Regulation 1525.4 are the same as provided in the initial statement of reasons.

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

The Board did not rely on any data or technical, theoretical, or empirical study, report, or similar document in proposing or adopting the proposed amendments to Regulation 1525.4 that was not identified in the initial statement of reasons, or which was otherwise not identified or made available for public review prior to the close of the public comment period.

In addition, the factual basis has not changed for the Board's initial determination that the proposed regulatory action will not have a significant adverse economic impact on business, the Board's determination that the proposed regulatory action is not a major regulation, as defined in Government Code section 11342.548 and California Code of Regulations, title 1, section 2000, and the Board's economic impact assessment, which determined that the Board's proposed regulatory action:

- 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; and
- Will not affect the benefits of Regulation 1525.4 to the health and welfare of California residents, worker safety, or the state's environment.

The proposed amendments to Regulation 1525.4 may affect small business.

<u>No Mandate on Local Agencies or School Districts</u>

The Board has determined that the adoption of the proposed amendments to Regulation 1525.4 does not impose a mandate on local agencies or school districts.

Public Comments

The Board received Ms. Shelton's November 10, 2015, letter regarding the proposed regulatory action and Ms. Twomey appeared at the public hearing on November 17, 2015, to comment on the proposed regulatory action. The Board considered the comments in the letter and the comments made during the public hearing before voting to adopt the proposed amendments and those comments are summarized and responded to above.

Determination Regarding Alternatives

By its motion on November 17, 2015, the Board determined that no alternative to the proposed amendments to Regulation 1525.4 would be more effective in carrying out the purposes for which the amendments are proposed, would be as effective and less burdensome to affected private persons than the adopted amendments, or would be more cost effective to affected private persons and equally effective in implementing the statutory policy or other provisions of the law.

The Board did not reject any reasonable alternatives to the proposed amendments to Regulation 1525.4 that would lessen any adverse impact the proposed amendments may have on small business.

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.

Updated Informative Digest for the

State Board of Equalization's Adoption of Proposed Amendments to

California Code of Regulations, Title 18, Section 1525.4,

Manufacturing and Research & Development Equipment

The State Board of Equalization (Board) held a public hearing regarding the proposed amendments to California Code of Regulations, title 18, section (Regulation) 1525.4, *Manufacturing and Research & Development Equipment*, on November 17, 2015.

Prior to the public hearing, the Board received a letter dated November 10, 2015, from Ms. Kristin Shelton, Program Budget Manager for the Department of Finance, objecting that the Board lacks the authority to adopt the proposed amendments and that the Board did not adequately assess the economic impact of the proposed amendments. Also, Ms. Therese Twomey, Fiscal Policy Director for the California Taxpayers Association (CalTax), appeared at the November 17, 2015, public hearing, urged the Board to adopt the proposed amendments, said that the Board does have authority to adopt the proposed amendments, and said that the Board properly determined that there is no economic impact from the proposed amendments.

The Board considered the comments in Ms. Shelton's letter and the comments made during the public hearing, and then, at the conclusion of the public hearing, the Board voted to adopt the proposed amendments to Regulation 1525.4 without making any changes. Ms. Shelton's letter and Ms. Twomey's comments are summarized and responded to in more detail in the final statement of reasons.

The notice of proposed regulatory action explains that the Board is proposing to adopt amendments to Regulation 1525.4 to further implement, interpret, and make specific the partial exemption from sales and use tax provided by Revenue and Taxation Code (RTC) section 6377.1. The partial exemption became effective on July 1, 2014, and is not being utilized as anticipated and intended by the Legislature, which may be due to the ambiguity in RTC section 6377.1 that the amendments are intended to clarify. Also, once the proposed amendments are effective, the clarification 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 the proposed clarifying amendments to Regulation 1525.4 in order to help ensure that the partial exemption begins to be utilized as originally anticipated and intended by the Legislature, as soon as possible, and the Board requests that the proposed amendments to Regulation 1525.4 be effective immediately upon filing with the Secretary of State, pursuant to Government Code section 11343.4, subdivision (b)(3).

There have not been any changes to the applicable laws or the effect of, the objective of, and anticipated benefits from the adoption of the proposed amendments to Regulation 1525.4 described in the informative digest included in the notice of proposed regulatory action. The informative digest included in the notice of proposed regulatory action provides:

Summary of Existing Laws and Regulations

As a general matter, California's Sales and Use Tax Law (Rev. & Tax. Code (RTC), § 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; Reg. 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, § 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; Regs. 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, the composition of the 7.50 percent rate is discussed in the initial statement of reasons, and the combined tax rate is higher than 7.50 percent 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.).

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 exemption provided by RTC section 6377.1, subdivision (a), is referred to as a partial exemption because RTC section 6377.1, subdivision (d), specifies that the 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; and 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.

RTC section 6377.1, subdivision (a), provides that the partial exemption provided by RTC section 6377.1 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.

As relevant here, RTC section 6377.1, subdivision (b)(7), defines the term "qualified tangible personal property," as follows for purposes of the partial exemption:

> (7)(A) "Qualified tangible personal property" includes, but is not limited to, all of the following:
> (i) Machinery and equipment, including component parts and contrivances such as belts, shafts, moving parts, and operating structures.
> (ii) 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.
> (iii) Tangible personal property used in pollution control that meets standards established by this state or any local or regional governmental agency within this state.
> (iv) 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.
> (B) "Qualified tangible personal property" shall not include any of the following:
> (i) Consumables with a useful life of less than one year.
> (ii) 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.
> (iii) Tangible personal property used primarily in administration, general management, or marketing.

As relevant here, RTC section 6377.1, subdivision (b)(10), defines the term "useful life," which is used in the definition of "qualified tangible personal property." Subdivision (b)(10) provides that "'Useful life' for tangible personal property that is treated 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 section. '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 purposes of this section" (hereafter also referred to as the "deemed" provisions of RTC section 6377.1).

Also, as relevant here, the Legislature intended for the partial exemption provided by RTC section 6377.1 to be fully utilized and, to ensure such utilization, RTC section 6377.1, subdivision (g), provides that:

> (g)(1) Upon the effective date of this section, the Department of Finance shall estimate the total dollar amount of exemptions that will be taken for each calendar year, or any portion thereof, for which this section provides an exemption.
> (2) No later than each March 1 next following a calendar year for which this section provides an exemption, the board shall provide to the Joint Legislative Budget Committee a report of the total dollar amount of exemptions taken under this section for the immediately preceding calendar year. The report shall compare the total dollar amount of exemptions taken under this section for that calendar year with the department's estimate for that same calendar year. If that total dollar amount taken is less than the estimate for that calendar year, the report shall identify options for increasing exemptions taken so as to meet estimated amounts.

In addition, the Board adopted Regulation 1525.4 to have the effect and accomplish the objective of fully implementing, interpreting, and making specific the provisions of RTC section 6377.1 on April 22, 2014, and the

regulation became effective on September 25, 2014. As relevant here, Regulation 1525.4, subdivision (b)(9), incorporates the definition of "qualified tangible personal property" from RTC section 6377.1, subdivision (b)(7) (with some minor clarifications that are not relevant here). And, Regulation 1525.4, subdivision (b)(13), incorporates the definition of "useful life" from the "deemed" provisions of RTC section 6377.1, and provides as follows:

> (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.

Furthermore, as relevant here, for federal income tax purposes:

- A taxpayer is generally allowed a current deduction, under Internal Revenue Code (IRC) section 162, for the entire cost of tangible personal property used in a trade or business that has a useful life of 12-months or less;
- A taxpayer is allowed to capitalize the cost of tangible personal property that is used in a trade or business and has a useful life of more than 12 months, and a taxpayer is only generally allowed to annually claim a depreciation deduction for part of the cost of the property (or capital asset) as it is exhausted over its useful life, under IRC section 167; and
- A taxpayer also is generally permitted to "elect" to treat the entire cost of tangible personal property used in a trade or business with a useful life of more than 12 months as a current deduction, under IRC section 179, subject to certain limitations that are not relevant here.

Both California's Personal Income Tax Law (RTC, § 17001 et seq.) and Corporation Tax Law (RTC, § 23001 et seq.) either generally incorporate or contain similar provisions to IRC sections 162, 167, and 179. (See, RTC, §§ 17201, 24343, 24349, 24356, subd. (b)(1)). Therefore, for state franchise and income tax purposes, a qualified person (as defined in RTC, § 6377.1) may treat the entire cost of otherwise qualified tangible personal property with a useful life of exactly one year (or 12 months) as a current deduction, under the provisions of IRC section 162 incorporated into or contained in California law, and may either treat all or a part of the cost of otherwise qualified tangible personal property with a useful life of more than one year (or 12 months) as a current deduction, under the provisions

of IRC sections 167 and 179 incorporated into or contained in California law.

Effect, Objective, and Benefits of the Proposed Amendments to Regulation 1525.4

Rulemaking Petition

On Tuesday, July 21, 2015, the Board's Legal Department received a petition dated July 21, 2015, from Ms. Teresa Casazza on behalf of the California Taxpayers Association (CalTax), pursuant to Government Code section 11340.6, requesting that the Board amend Regulation 1525.4 to add clarifying language so that taxpayers may substantiate that tangible personal property satisfies the useful life qualification in RTC section 6377.1 by reference to either warranties, maintenance agreements, or industry replacement standards. The petition explained that:

> 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.

The attachment to the petition also specifically recommended that the Board amend Regulation 1525.4, subdivision (b)(13), to read as follows:

(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 [personal] 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.

Chief Counsel Memorandum

The Board's Legal Department prepared a Chief Counsel Memorandum dated August 3, 2015, which set forth relevant background information pertaining to the adoption of Regulation 1525.4, provided a discussion of

CalTax's petition, and provided Board staff's response. CalTax's petition and Formal Issue Paper 14-001 regarding the Board's adoption of Regulation 1525.4 were also included as attachments to the Chief Counsel Memorandum.

The Chief Counsel Memorandum explained that staff "recognizes that [RTC] 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 [the] '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 [with a useful life of more than one year] 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."

The Chief Counsel Memorandum explained that "CalTax asserts that the explicit language in subdivision (b)(7)(A)(i) makes it clear that the Legislature intended [for the partial exemption to apply to] the component parts and contrivances of machinery and equipment. CalTax further asserts that limiting the [partial] exemption [by narrowly applying] subdivision (b)(10) of that section would needlessly thwart the purpose and intent of RTC section 6377.1."

The Chief Counsel Memorandum also advised the Board, that "[i]f 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, [then,] subject to approval by the Office of Administrative Law [(OAL)], CalTax's requested amendments will address the issues raised by CalTax and effectuate such legislative intent."

August 25, 2015, Board Meeting

The Chief Counsel Memorandum dated August 3, 2015, and CalTax's petition were submitted to the Board Members for consideration during the Board's August 25, 2015, meeting. During the meeting, Board staff introduced the agenda item. Board staff said that, "[a]lthough staff has concerns about the 'deemed' provisions of [RTC] section 6377.1, [staff understands] the perceived ambiguities in the [entire] section's wording and [staff realizes] that reasonable minds may differ on its interpretation."

Board staff said that "[i]f the Board agrees, in light of the entire statutory scheme, [that] 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 the approval by [OAL], [Caltax's] proposed amendment[s] will address the issues raised by CalTax and effectuate such legislative intent." Staff also said that staff did not "regard [CalTax's] proposal as having a revenue impact since, subject to the approval by [OAL], [the requested amendments] would be regarded as consistent with the implementing statute." Furthermore, staff said that "for the first year, the [partial] exemption usage was anticipated to be [based on] approximately $15 billion [of expenditures]. However, based upon returns to date, we have [only] seen approximately $3 billion of usage," which may be due to the perceived ambiguities in the statute.

During the discussion of the item, Ms. Therese Twomey, Fiscal Policy Director for CalTax, asked the Board to grant the petition to add the clarifying language to Regulation 1525.4. Ms. Twomey said that "there is ambiguity in the statute," the "ambiguity has prohibited some taxpayers [from qualifying] for the exemption" and, therefore, prevented the partial exemption from generating "the economic activity that was intended by the Legislature" to help increase manufacturing and manufacturing jobs in California. Ms. Twomey also said that CalTax's requested amendments will "allow California taxpayers to better verify and to have the Board substantiate that the 'useful life' language can be substantiated through either a warranty that lasts more than one year, a maintenance contract that lasts more than one year, or industry replacement standards that last for more than one year."

In addition, Ms. Twomey pointed out that RTC section 6377.1, subdivision (g), "itself asks the [Board] to take a look at utilization as well as to compare the utilization to the amount that was estimated, and in the event that that utilization is lower than what is estimated, that the Board make recommendations and pursue changes in order to garner the amount that was initially intended and the economic activity that was intended." She also said that CalTax has "discussed [utilization] with the Department of Finance. And as a matter of fact, they have been asking [CalTax] why utilization is so low" and they are relying on CalTax "to provide the industry's perspective as to why. . . ."

Furthermore, during the discussion of the item, Deputy State Controller Yvette Stowers said that she and State Controller Betty Yee "support having businesses benefit from this exemption and we acknowledge that it is underutilized." However, she also expressed the concern that the useful life requirement "needs to be fixed in the statute first, as opposed to the

regulation" and she said "[f]or that fact" she would "not be voting yes to accept the petition."

In response, Board Chairman Jerome Horton agreed with Ms. Stowers that it would be good to have a statutory fix, but he also expressed serious concerns about the underutilization of the partial exemption and the delays associated with solely pursuing a statutory fix. So, Chairman Horton urged the Board to try to fix the situation by amending the regulation as requested by CalTax.

Also, Board Members George Runner, Diane Harkey and Fiona Ma agreed with Chairman Horton that the Board should try to fix the situation by amending the regulation as requested by CalTax. Both Chairman Horton and Board Member Runner expressed their understanding that OAL would serve as a "backstop" if a statutory fix is legally required before the Board can amend the regulation. And, Board Member Ma explained that, based upon her experience in the Legislature, the Legislature does not have the time to specifically address every regulatory issue in proposed legislation, and the Legislature often enacts legislation with the expectation that the implementing agencies will adopt regulations to address specific regulatory issues when necessary.

At the conclusion of the Board discussion of the item, Chairman Horton and Board Members Harkey, Runner, and Ma voted to grant CalTax's petition and propose the requested amendments to Regulation 1525.4. The Board determined that there is an issue because RTC section 6377.1 does not specify whether a qualified person who currently deducts the entire cost of otherwise qualified tangible personal property that actually has a useful life of one or more years is "treating" such property as having a useful life of less than one year or a useful life of one or more years for state franchise and income tax purposes. RTC section 6377.1 does not expressly state that its "deemed" provisions are the exclusive means by which a qualified person may substantiate that otherwise qualified tangible personal property has a useful life of one or more years for purposes of the partial exemption. RTC section 6377.1 does not provide other reasonable means to establish that otherwise qualified tangible personal property has a useful life of one or more years. And, the lack of specificity creates an ambiguity as to whether it is permissible to use other reasonable methods to substantiate the useful life of otherwise qualified tangible personal property under the statute. The Board also determined that the amendments requested in CalTax's petition are reasonably necessary to have the effect and accomplish the objective of addressing the issue created by the ambiguity in the statute by adding clarifying provisions to the regulation expressly permitting taxpayers to substantiate the useful life of otherwise qualified tangible personal property using other reasonable means, including a warranty, service contract, or industry practice.

The Board anticipates that the proposed amendments will benefit qualified persons who deduct, rather than capitalize, the cost of otherwise qualified tangible personal property on their state franchise and income tax returns by clarifying that they may substantiate that such property satisfies the "useful life" requirements for the partial exemption provided by RTC section 6377.1 using a warranty, service contract, or industry practice. The Board anticipates that the proposed amendments will benefit all taxpayers by promoting fairness and helping ensure that similarly situated taxpayers, such as Taxpayer A and Taxpayer B referred to in CalTax's petition, do not receive disparate treatment. The Board also anticipates that the proposed amendments will generally benefit the people of the State of California by helping ensure that the partial exemption provided by RTC section 6377.1 is utilized as originally anticipated by the Legislature and that the statute increases manufacturing and manufacturing jobs in California as the Legislature intended.

The Board has performed an evaluation of whether the proposed amendments to Regulation 1525.4 are inconsistent or incompatible with existing state regulations and determined that the proposed amendments are not inconsistent or incompatible with existing state regulations. This is because Regulation 1525.4 is the only state regulation that specifically implements, interprets, and makes specific the provisions of RTC section 6377.1, and the proposed amendments to Regulation 1525.4 clarify and are consistent with the regulation's current provisions. In addition, the Board has determined that there are no comparable federal regulations or statutes to Regulation 1525.4 or the proposed amendments to Regulation 1525.4.

State of California

Board of Equalization
Legal Department-MIC:83
Office of the Chief Counsel
(916) 445-4380
Fax: (916) 322-0341

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

CalTax℠
Established 1926

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,

Teresa Casazza

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

BOARD OF EQUALIZATION
KEY AGENCY ISSUE

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 6051[1], 6051.3, 6201[2], 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 revisions[3].

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.

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[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 rule 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 investment[4]. 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."

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 <u>or products</u> 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

Current as of: April 2, 2014

BEFORE THE CALIFORNIA STATE BOARD OF EQUALIZATION

5901 GREEN VALLEY CIRCLE

CULVER CITY, CALIFORNIA

REPORTER'S TRANSCRIPT

AUGUST 25, 2015

CHIEF COUNSEL MATTERS

J RULEMAKING

J1 PETITION TO AMEND SALES AND USE TAX

REGULATION 1525.4, MANUFACTURING AND RESEARCH &

DEVELOPMENT EQUIPMENT

REPORTED BY: Kathleen Skidgel

CSR NO. 9039

Electronically signed by Kathleen Skidgel (601-100-826-6264) 85bef72f-1789-4994-b48a-04e6a61e92c3

1 P R E S E N T

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3 For the Board of Equalization: Jerome E. Horton
Chairman

4

5 Sen. George Runner (Ret.)
Vice Chair

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7 Fiona Ma, CPA
Member

8

9 Diane L. Harkey
Member

10

11 Yvette Stowers
Appearing for Betty T.
12 Yee, State Controller
(per Government Code
13 Section 7.9)

14

Joann Richmond
15 Chief
Board Proceedings
16 Division

17 For Staff: Robert Tucker
Assistant Chief Counsel
18 Legal Department

19 Speaker: Therese Twomey
Fiscal Policy Director
20 California Taxpayers
Association

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1 5901 GREEN VALLEY CIRCLE
2 CULVER CITY, CALIFORNIA
3 AUGUST 25, 2015
4 ---oOo---
5 MR. HORTON: Ms. Richmond, our next matter.
6 MS. RICHMOND: Our next matter is the Chief
7 Counsel matter, Item J, Rulemaking; J1, Petition to
8 Amend Sales and Use Tax Regulation 1525.4,
9 Manufacturing and Research and Development
10 Equipment.
11 And we do have someone that wishes to make
12 a public comment.
13 MR. HORTON: Thank you.
14 I would ask Therese Twomey to please come
15 forward. Welcome to the Board. We thank you and
16 appreciate your time traveling to southern
17 California.
18 Mr. Tucker, would you please introduce the
19 issues in this case.
20 MR. TUCKER: Yes. A petition to amend
21 Regulation 1525.4 was submitted by the California
22 Taxpayers Association. The petition offers
23 additional means to substantiate useful life of
24 property subject to the partial exemption.
25 Although staff has concerns about the
26 "deemed" provision of Revenue and Taxation Code
27 section 6377.1, we understand the perceived
28 ambiguities in the section's wording and we realize

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1 that reasonable minds can differ on its
2 interpretation.
3 We do not regard this proposal as having a
4 revenue impact since, subject to the approval by the
5 Office of Administrative Law, it would be regarded
6 as consistent with the implementing statute.
7 Furthermore, for the first year, the exemption usage
8 was anticipated to be approximately $15 billion.
9 However, based upon returns to date, we have seen
10 approximately $3 billion of usage.
11 Today the Board can choose to: (1) deny the
12 petition; (2) grant the petition in part or in whole
13 and commence with the official rulemaking; (3)
14 direct staff to start the interested parties
15 process; or (4) take whatever action the Board deems
16 appropriate.
17 If the Board agrees, in light of the entire
18 statutory scheme, the Legislature intended to make
19 the partial exemption available in all circumstances
20 where a qualified person can establish that
21 otherwise qualified tangible personal property has a
22 useful life of one year or more, subject to the
23 approval by the Office of Administrative Law, this
24 proposed amendment will address the issues raised by
25 CalTax and effectuate such a legislative intent.
26 In the event the petition is granted, staff
27 would prepare and publish a notice for the November
28 Board hearing. If the amendments are adopted at

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1 that public hearing, then staff would anticipate
2 filing with the Office of Administrative Law before
3 the end of the year, and the amendments would be
4 effective April 1st, 2016.
5 Thank you.
6 MR. HORTON: Members, let us hear from the
7 Fiscal Policy Director of the California Taxpayers
8 Association, Ms. Therese Twomey.
9 ---oOo---
10 THERESE TWOMEY
11 ---oOo---
12 MS. TWOMEY: Mr. Chair and Members, thank
13 you very much.
14 Thank you for the opportunity to come here
15 before you. And, also, thank you for allowing me
16 the opportunity to sit behind Rob Lowe and kind of
17 stare at the back of his head. Still a little bit
18 giddy about that.
19 On a more serious --
20 MR. HORTON: Love is in the air.
21 MS. TWOMEY: I'm not sure about love, but
22 definitely admiration.
23 MS. HARKEY: His -- his wife was right
24 there.
25 MS. TWOMEY: Yes, that's why I didn't touch
26 him.
27 MR. HORTON: Okay, Members.
28 MS. TWOMEY: But on a serious note, thank

1 you for your continued leadership on this very
2 important issue.
3 I'd also like to take this opportunity to
4 thank your staff, as well as Board staff, for all of
5 their work and dedication on this issue. It's been
6 two years in the making and California's just
7 starting to implement this process and let other
8 states know that California's once again trying to
9 make ourselves more competitive with other states.
10 We are here today to ask you to approve
11 clarifying language and add that language to
12 Regulation 1525.4. As your staff have indicated,
13 there is ambiguity in the statute and in the
14 language itself; and this language and its ambiguity
15 has prohibited some taxpayers by -- to qualify for
16 the exemption and, therefore, generate the economic
17 activity that was intended by the Legislature.
18 This generated economic activity was
19 intended by the Legislature as a result of the
20 manufacturing that has left California. We're here
21 to ask you to help California come back and retrieve
22 those manufacturing jobs that have been lost.
23 Specifically, we're asking that the
24 language be added to allow California taxpayers to
25 better verify and to have the Board substantiate
26 that the "useful life" language can be substantiated
27 through either a warranty that lasts more than one
28 year, a maintenance contract that lasts more than

1 one year, or industry replacement standards that
2 last for more than one year.
3 And we ask that you approve option number
4 (2) which is to initiate the regulatory rulemaking
5 process through public notice.
6 Thank you for your time.
7 MR. HORTON: Quick -- question.
8 What are your thoughts about the argument
9 that this should be done through budget trailing or
10 statute and that the timing is -- given that
11 it'll -- this won't go into effect until April, the
12 timing is the same and possibly running dual
13 parallel tracks in order to make sure that the
14 desires are ultimately reached?
15 MS. TWOMEY: Thank you very much for the
16 question, Mr. Chair.
17 The statute itself asks the Board of
18 Equalization to take a look at utilization as well
19 as to compare the utilization to the amount that was
20 estimated, and in the event that that utilization is
21 lower than what is estimated, that the Board make
22 recommendations and pursue changes in order to
23 garner the amount that was initially intended and
24 the economic activity that was intended.
25 We have discussed this with the Department
26 of Finance. And as a matter of fact, they have been
27 asking us why utilization is so low. They've relied
28 on us to provide the industry's perspective as to

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1 why this is not being utilized.
2 Their discussion with us indicated that,
3 since we came in a little bit late in the May
4 revise, they would like to take a look at it in the
5 January budget process; but as you've indicated and
6 as you all know, that would delay this process for
7 industry.
8 If we were to get legislation, it's likely
9 that it may not be signed until two months later.
10 And as this is a time-sensitive issue since we don't
11 have a lot of time to try to get this fixed, we'd
12 like to ask the Board to expedite this and get this
13 clarification fixed as quickly as possible.
14 MR. HORTON: Discussion, Member?
15 Member Harkey.
16 MS. HARKEY: This doesn't fix everything
17 for you, is what you're saying in essence, correct?
18 MS. TWOMEY: This is just to fix a small
19 ambiguity.
20 One of the issues, you know, has to do with
21 "useful life" and how to qualify. But, absolutely,
22 I think there are other ways that this exemption can
23 be improved to maximize utilization.
24 As your staff indicated, we are way, way
25 under-utilizing this because of some of the
26 barriers. But this will help move us towards -- you
27 know, in the right direction and start with
28 clarifying language.

1 MS. HARKEY: Right. And I -- I had been --
2 I was involved early on in determining that it
3 probably had to be done through the Legislature in
4 order to -- because the statute had mirrored the,
5 uh -- the regulation, or the regulation mirrored the
6 statute. And we went through a long discussion
7 about this with many of your -- of your members.
8 And so I know there's some other items that need to
9 be reconciled here and it may be a longer process.
10 So I would encourage the Board to grant
11 this petition, and then we can move it just that
12 step forward, a little bit forward.
13 MR. HORTON: We'll accept that as a grant
14 of petition and hold to commence the official
15 rulemaking process and to amend the regulation.
16 Is there a second?
17 MR. RUNNER: Second.
18 MS. STOWERS: I have a comment.
19 MR. HORTON: Further discussion, Member?
20 Member Stowers.
21 MS. STOWERS: Thank you.
22 CalTax, thank you for looking into this
23 issue. I know I wanted to say you guys have been
24 really dedicated, trying to find a resolution to the
25 problem.
26 Myself and Ms. Yee definitely support
27 having businesses benefit from this exemption and we
28 acknowledge that it is under-utilized. Not sure if

1 it's because of a problem within the statute with
2 "useful life" or if it's just because the exemption
3 amount is just not enough to encourage them to
4 accelerate their -- their investments in California.
5 But that being said, I am under the
6 impression that the requirement needs to be fixed in
7 the statute first, as opposed to the regulation.
8 And for that, I will not be voting yes to accept the
9 petition.
10 MR. HORTON: Okay. Thank you.
11 Further discussion, Members?
12 I think it should be fixed through statute
13 as well. However, what the hey, you know, let's see
14 if we can get it done.
15 MR. RUNNER: Right.
16 MR. HORTON: I mean that's -- that's sort
17 of my view. Even if we could expand it to do all
18 the other things, I mean the only thing that stands
19 in front of us is the Office of Administrative
20 Law --
21 MR. RUNNER: Right.
22 MR. HORTON: -- and they'll always be
23 there.
24 So, that's my thoughts.
25 There's a motion on the floor.
26 MR. RUNNER: Let me, real quick.
27 MR. HORTON: Objection noted.
28 Member Runner.

1 MR. RUNNER: Yeah -- yeah, I would agree.
2 I think the backstop there if we go beyond what we
3 need to do is AO -- is the Office of Administrative
4 Law. So I think there's a backstop there if we go
5 beyond what we need to, or should.
6 But I think the other side weighs more
7 heavily, I think, for us. And that is, how can we
8 expedite this process in order to grow business in
9 the State of California?
10 That being said, let me -- I have a
11 question to CalTax. There are some other items that
12 I think you're wanting to address.
13 MS. TWOMEY: Not in this petition.
14 MR. RUNNER: Well, right. I understand
15 that. But let me ask you this, because one of the
16 other issues that I would have a question about is
17 whether or not there are some things -- for
18 instance, if you would think it would be helpful if
19 we did interested parties or other kind of
20 discussions in those other items in preparation then
21 for what would be taking place next year?
22 I would just let CalTax decide if that --
23 if there's an involvement that we should have,
24 outside of this petition, to try to deal with some
25 of those other issues, I think we ought to take that
26 under consideration at some time, too.
27 MS. TWOMEY: Yes, thank you. And we will
28 be coming back to you --

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1 MR. RUNNER: Okay.
2 MS. TWOMEY: -- after we take a look at the
3 remaining items and talk to all of the Board Members
4 about that.
5 MR. RUNNER: Thank you.
6 MS. TWOMEY: Thank you.
7 MR. HORTON: Member Harkey.
8 MS. HARKEY: We -- we would be happy to
9 review this under Business Tax Committee and get --
10 get the process rolling and see if we can move it
11 along.
12 MS. TWOMEY: Thank you.
13 MR. HORTON: Members, I might recommend as
14 well is that whenever you have a situation where
15 only 200 million or -- what is it -- 35 percent,
16 somewhere around there, of the tax credit is being
17 used, the communication to the Legislature is is
18 that the other 65 percent is unused and we can use
19 it for something else.
20 And so I would certainly encourage that we
21 begin the process now through the Business Taxes as
22 it relates to the rulemaking, but also through the
23 Legislative Committee as it relates to legislation,
24 budgetary changes, to begin to have that discussion
25 about all the other items, at least for a minimum to
26 be able to share with the Legislature, give the
27 Legislature the benefit of that deliberation.
28 Without that, the first of the year, what this is is

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1 $400 million for whatever they want to use it for.
2 So there's a motion on the -- on the -- on
3 the floor.
4 MS. MA: I just want to add --
5 MR. HORTON: Discussion by Member Ma.
6 MS. MA: I just want to add that the
7 manufacturing tax credit has been discussed a lot
8 with many folks because of the confusion. And
9 that's what we do sometimes in the Legislature; you
10 know, we only have nine months, we pass it, not
11 really very specific, and we leave it to the
12 agencies to promulgate the rules and the regulation.
13 So, I agree with the Chairman that I'd like
14 to see us try to tackle this. And if not, then, you
15 know, we can run legislation. And as the Chair, I'm
16 more than happy to work with you to accomplish
17 that.
18 MS. TWOMEY: Thank you.
19 MR. HORTON: Ms. Richmond, please call the
20 roll.
21 MS. RICHMOND: Mr. Horton.
22 MR. HORTON: Aye.
23 MS. RICHMOND: Ms. Harkey.
24 MS. HARKEY: Aye.
25 MS. RICHMOND: Mr. Runner.
26 MR. RUNNER: Aye.
27 MS. RICHMOND: Ms. Ma.
28 MS. MA: Aye.

1 MS. RICHMOND: Ms. Stowers.
2 MS. STOWERS: No.
3 MS. RICHMOND: Motion carries.
4 MR. HORTON: Thank you very much.
5 ---oOo---
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1 REPORTER'S CERTIFICATE

2

3 State of California)

4) ss

5 County of Sacramento)

6

7 I, KATHLEEN SKIDGEL, Hearing Reporter for

8 the California State Board of Equalization certify

9 that on August 25, 2015 I recorded verbatim, in

10 shorthand, to the best of my ability, the

11 proceedings in the above-entitled hearing; that I

12 transcribed the shorthand writing into typewriting;

13 and that the preceding pages 1 through 14 constitute

14 a complete and accurate transcription of the

15 shorthand writing.

16

17 Dated: August 28, 2015

18

19

20 Kathleen Skidgel

21 KATHLEEN SKIDGEL, CSR #9039

22 Hearing Reporter

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ESTIMATE OF COST OR SAVINGS RESULTING FROM PROPOSED REGULATORY ACTION

Proposed Amendment of Sales and Use Tax Regulation 1525.4, *Manufacturing and Research & Development Equipment*

STATEMENT OF COST OR SAVINGS FOR NOTICE OF PUBLIC HEARING

The State Board of Equalization has determined that the proposed action does not impose a mandate on local agencies or school districts. Further, the Board has determined that the action will result in no direct or indirect cost or savings to any State agency, any local agency or school district that is required to be reimbursed under Part 7 (commencing with Section 17500) of Division 4 of Title 2 of the Government Code or other non-discretionary cost or savings imposed on local agencies, or cost or savings in Federal funding to the State of California.

The cost impact on private persons or businesses will be insignificant. This proposal will not have a significant adverse economic impact on businesses.

This proposal will not be detrimental to California businesses in competing with businesses in other states.

This proposal will neither create nor eliminate jobs in the State of California nor result in the elimination of existing businesses or create or expand business in the State of California.

Statement Prepared by _____ Date 9-17-15
Richard Bennion, Regulations Coordinator

Approved by _____ Date 9/17/15
Randy Ferris, Chief Counsel

If Costs or Savings are Identified, Signatures of Chief, Fiscal Management Division, and Chief, Board Proceedings Division, are Required

Approved by _____ Date _____
Chief, Financial Management Division

Approved by _____ Date _____
Chief, Board Proceedings Division

NOTE: **SAM Section 6615 requires that estimates resulting in cost or savings be submitted for Department of Finance concurrence before the notice of proposed regulatory action is released.**

STATE OF CALIFORNIA — DEPARTMENT OF FINANCE

ECONOMIC AND FISCAL IMPACT STATEMENT (REGULATIONS AND ORDERS)

STD. 399 (REV. 12/2013)

Instructions and Code Citations: SAM Section 6601-6616

ECONOMIC IMPACT STATEMENT

DEPARTMENT NAME	CONTACT PERSON	EMAIL ADDRESS	TELEPHONE NUMBER
State Board of Equalization	Richard E. Bennion	rbennion@boe.ca.gov	916-445-2130

DESCRIPTIVE TITLE FROM NOTICE REGISTER OR FORM 400	NOTICE FILE NUMBER
Title 18, Section 1525.4, Manufacturing and Research & Development Equipment	Z

A. ESTIMATED PRIVATE SECTOR COST IMPACTS *Include calculations and assumptions in the rulemaking record.*

1. Check the appropriate box(es) below to indicate whether this regulation:

- ☐ a. Impacts business and/or employees
- ☐ b. Impacts small businesses
- ☐ c. Impacts jobs or occupations
- ☐ d. Impacts California competitiveness
- ☐ e. Imposes reporting requirements
- ☐ f. Imposes prescriptive instead of performance
- ☐ g. Impacts individuals
- ☒ h. None of the above (Explain below):

Please see the attached .

If any box in Items 1 a through g is checked, complete this Economic Impact Statement.
If box in Item 1.h. is checked, complete the Fiscal Impact Statement as appropriate.

2. The _____ (Agency/Department) estimates that the economic impact of this regulation (which includes the fiscal impact) is:

- ☐ Below $10 million
- ☐ Between $10 and $25 million
- ☐ Between $25 and $50 million
- ☐ Over $50 million *[If the economic impact is over $50 million, agencies are required to submit a Standardized Regulatory Impact Assessment as specified in Government Code Section 11346.3(c)]*

3. Enter the total number of businesses impacted: _____

Describe the types of businesses (Include nonprofits): _____

Enter the number or percentage of total businesses impacted that are small businesses: _____

4. Enter the number of businesses that will be created: _____ eliminated: _____

Explain: _____

5. Indicate the geographic extent of impacts: ☐ Statewide ☐ Local or regional (List areas): _____

6. Enter the number of jobs created: _____ and eliminated: _____

Describe the types of jobs or occupations impacted: _____

7. Will the regulation affect the ability of California businesses to compete with other states by making it more costly to produce goods or services here? ☐ YES ☐ NO

If YES, explain briefly: _____

Instructions and Code Citations:
SAM Section 6601-6616

ECONOMIC IMPACT STATEMENT (CONTINUED)

STIMATED COSTS *Include calculations and assumptions in the rulemaking record.*

1. What are the total statewide dollar costs that businesses and individuals may incur to comply with this regulation over its lifetime? $ _____

   a. Initial costs for a small business: $ _____ Annual ongoing costs: $ _____ Years: _____

   b. Initial costs for a typical business: $ _____ Annual ongoing costs: $ _____ Years: _____

   c. Initial costs for an individual: $ _____ Annual ongoing costs: $ _____ Years: _____

   d. Describe other economic costs that may occur: _____

2. If multiple industries are impacted, enter the share of total costs for each industry: _____

3. If the regulation imposes reporting requirements, enter the annual costs a typical business may incur to comply with these requirements. *Include the dollar costs to do programming, record keeping, reporting, and other paperwork, whether or not the paperwork must be submitted.* $ _____

4. Will this regulation directly impact housing costs? ☐ YES ☐ NO

   If YES, enter the annual dollar cost per housing unit: $ _____

   Number of units: _____

5. Are there comparable Federal regulations? ☐ YES ☐ NO

   xplain the need for State regulation given the existence or absence of Federal regulations: _____

   Enter any additional costs to businesses and/or individuals that may be due to State - Federal differences: $ _____

C. ESTIMATED BENEFITS *Estimation of the dollar value of benefits is not specifically required by rulemaking law, but encouraged.*

1. Briefly summarize the benefits of the regulation, which may include among others, the health and welfare of California residents, worker safety and the State's environment: _____

2. Are the benefits the result of: ☐ specific statutory requirements, or ☐ goals developed by the agency based on broad statutory authority?

   Explain: _____

3. What are the total statewide benefits from this regulation over its lifetime? $ _____

4. Briefly describe any expansion of businesses currently doing business within the State of California that would result from this regulation: _____

D. ALTERNATIVES TO THE REGULATION *Include calculations and assumptions in the rulemaking record. Estimation of the dollar value of benefits is not specifically required by rulemaking law, but encouraged.*

1. List alternatives considered and describe them below. If no alternatives were considered, explain why not: _____

Instructions and Code Citations:
SAM Section 6601-6616

ECONOMIC IMPACT STATEMENT (CONTINUED)

ımmarize the total statewide costs and benefits from this regulation and each alternative considered:

Regulation: Benefit: $ _____ Cost: $ _____

Alternative 1: Benefit: $ _____ Cost: $ _____

Alternative 2: Benefit: $ _____ Cost: $ _____

3. Briefly discuss any quantification issues that are relevant to a comparison of estimated costs and benefits for this regulation or alternatives: _____

4. Rulemaking law requires agencies to consider performance standards as an alternative, if a regulation mandates the use of specific technologies or equipment, or prescribes specific actions or procedures. Were performance standards considered to lower compliance costs? ☐ YES ☐ NO

Explain: _____

E. MAJOR REGULATIONS *Include calculations and assumptions in the rulemaking record.*

California Environmental Protection Agency (Cal/EPA) boards, offices and departments are required to submit the following (per Health and Safety Code section 57005). Otherwise, skip to E4.

1. Will the estimated costs of this regulation to California business enterprises **exceed $10 million**? ☐ YES ☐ NO

If YES, complete E2. and E3
If NO, skip to E4

riefly describe each alternative, or combination of alternatives, for which a cost-effectiveness analysis was performed:

Alternative 1: _____

Alternative 2: _____

(Attach additional pages for other alternatives)

3. For the regulation, and each alternative just described, enter the estimated total cost and overall cost-effectiveness ratio:

Regulation: Total Cost $ _____ Cost-effectiveness ratio: $ _____

Alternative 1: Total Cost $ _____ Cost-effectiveness ratio: $ _____

Alternative 2: Total Cost $ _____ Cost-effectiveness ratio: $ _____

4. Will the regulation subject to OAL review have an estimated economic impact to business enterprises and individuals located in or doing business in California exceeding $50 million in any 12-month period between the date the major regulation is estimated to be filed with the Secretary of State through12 months after the major regulation is estimated to be fully implemented?

☐ YES ☐ NO

If YES, agencies are required to submit a Standardized Regulatory Impact Assessment (SRIA) as specified in Government Code Section 11346.3(c) and to include the SRIA in the Initial Statement of Reasons.

5. Briefly describe the following:

The increase or decrease of investment in the State: _____

The incentive for innovation in products, materials or processes: _____

The benefits of the regulations, including, but not limited to, benefits to the health, safety, and welfare of California residents, worker safety, and the state's environment and quality of life, among any other benefits identified by the agency: _____

STATE OF CALIFORNIA — DEPARTMENT OF FINANCE

ECONOMIC AND FISCAL IMPACT STATEMENT
(REGULATIONS AND ORDERS)

STD 399 (REV. 12/2013)

SAM Section 6601-6616

FISCAL IMPACT STATEMENT

A. FISCAL EFFECT ON LOCAL GOVERNMENT *Indicate appropriate boxes 1 through 6 and attach calculations and assumptions of fiscal impact for the current year and two subsequent Fiscal Years.*

☐ 1. Additional expenditures in the current State Fiscal Year which are reimbursable by the State. (Approximate) (Pursuant to Section 6 of Article XIII B of the California Constitution and Sections 17500 et seq. of the Government Code).

$ _____

☐ a. Funding provided in _____

Budget Act of _____ or Chapter _____, Statutes of _____

☐ b. Funding will be requested in the Governor's Budget Act of _____

Fiscal Year: _____

☐ 2. Additional expenditures in the current State Fiscal Year which are NOT reimbursable by the State. (Approximate) (Pursuant to Section 6 of Article XIII B of the California Constitution and Sections 17500 et seq. of the Government Code).

$ _____

Check reason(s) this regulation is not reimbursable and provide the appropriate information:

☐ a. Implements the Federal mandate contained in _____

☐ b. Implements the court mandate set forth by the _____ Court.

Case of: _____ vs. _____

☐ c. Implements a mandate of the people of this State expressed in their approval of Proposition No. _____

Date of Election: _____

☐ d. Issued only in response to a specific request from affected local entity(s).

Local entity(s) affected: _____

☐ e. Will be fully financed from the fees, revenue, etc. from: _____

Authorized by Section: _____ of the _____ Code;

☐ f. Provides for savings to each affected unit of local government which will, at a minimum, offset any additional costs to each;

☐ g. Creates, eliminates, or changes the penalty for a new crime or infraction contained in _____

☐ 3. Annual Savings. (approximate)

$ _____

☐ 4. No additional costs or savings. This regulation makes only technical, non-substantive or clarifying changes to current law regulations.

☒ 5. No fiscal impact exists. This regulation does not affect any local entity or program.

☐ 6. Other. Explain _____

Instructions and Code Citations:
SAM Section 6601-6616

FISCAL IMPACT STATEMENT (CONTINUED)

FISCAL EFFECT ON STATE GOVERNMENT *Indicate appropriate boxes 1 through 4 and attach calculations and assumptions of fiscal impact for the current year and two subsequent Fiscal Years.*

☐ 1. Additional expenditures in the current State Fiscal Year. (Approximate)

$ _____

It is anticipated that State agencies will:

☐ a. Absorb these additional costs within their existing budgets and resources.

☐ b. Increase the currently authorized budget level for the _____ Fiscal Year

☐ 2. Savings in the current State Fiscal Year. (Approximate)

$ _____

☒ 3. No fiscal impact exists. This regulation does not affect any State agency or program.

☐ 4. Other. Explain _____

C. FISCAL EFFECT ON FEDERAL FUNDING OF STATE PROGRAMS *Indicate appropriate boxes 1 through 4 and attach calculations and assumptions of fiscal impact for the current year and two subsequent Fiscal Years.*

☐ 1. Additional expenditures in the current State Fiscal Year. (Approximate)

$ _____

☐ 2. Savings in the current State Fiscal Year. (Approximate)

$ _____

☒ 3. No fiscal impact exists. This regulation does not affect any federally funded State agency or program.

☐ 4. Other. Explain _____

FISCAL OFFICER SIGNATURE	DATE
Joe Fitz	September 15, 2015

The signature attests that the agency has completed the STD. 399 according to the instructions in SAM sections 6601-6616, and understands the impacts of the proposed rulemaking. State boards, offices, or departments not under an Agency Secretary must have the form signed by the highest ranking official in the organization.

AGENCY SECRETARY	DATE
Joann Richmond	September 15, 2015

Finance approval and signature is required when SAM sections 6601-6616 require completion of Fiscal Impact Statement in the STD. 399.

DEPARTMENT OF FINANCE PROGRAM BUDGET MANAGER	DATE
Exempt under SAM section 6615	

Attachment to Economic and Fiscal Impact Statement (STD. 399 (Rev. 12/2013)) for the Proposed Amendments to California Code of Regulations, Title 18, Section 1525.4, *Manufacturing and Research & Development Equipment*

As explained in more detail in the initial statement of reasons, Revenue and Taxation Code (RTC) section 6377.1, as enacted by Assembly Bill No. (AB) 93 (Stats. 2013, ch. 69, effective July 11, 2013), and as amended by Senate Bill No. (SB) 90 (Stats. 2013, ch. 70, effective July 11, 2013), exempts from some of the taxes imposed under California's Sales and Use Tax Law (RTC, § 6001 et. seq.), on and after July 1, 2014, and before July 1, 2022, the gross receipts from the sale of, and the storage, use, or other consumption of, qualified tangible personal property: (1) purchased for use by a qualified person to be used primarily in the manufacturing, processing, refining, fabricating, or recycling of tangible personal property; (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 (1) or (2) above; and (4) and qualified tangible personal property purchased for use by a contractor for specified purposes.

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. Also, as explained in more detail in the initial statement of reasons, the Legislature intended for the partial exemption provided by RTC section 6377.1 to be fully utilized and, to ensure such utilization, RTC section 6377.1, subdivision (g), required the Department of Finance to estimate the total dollar amount of exemptions that will be taken for each calendar year the partial exemption will be in effect and requires the Board to annually report the total dollar amount of exemptions taken for the immediately preceding calendar year, compare the total dollar amount of those exemptions to the Department of Finance's estimate for that same year, and identify options for increasing exemptions taken so as to meet the Department of Finance's estimates when necessary. And, the Board anticipates that RTC section 6377.1 will continue to have an economic impact on business and state revenue as the Legislature intended.

As explained in more detail in the initial statement of reasons, RTC section 6377.1, subdivision (b)(7), requires that tangible personal property have a useful life of one or more years in order for that property to be "qualified tangible personal property" for purposes of the partial exemption, and RTC section 6377.1, subdivision (b)(10), provides that: "'Useful life' for tangible personal property that is treated 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 section. '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 purposes of this section."

The Board has determined that there is an issue because RTC section 6377.1 does not specify whether a qualified person who currently deducts the entire cost of otherwise qualified tangible personal property that actually has a useful life of one or more years is "treating" such property as having a useful life of less than one year or a useful life of one or more years for state

franchise and income tax purposes. RTC section 6377.1 does not expressly state that its "deemed" provisions are the exclusive means by which a qualified person may substantiate that otherwise qualified tangible personal property has a useful life of one or more years for purposes of the partial exemption. RTC section 6377.1 does not provide other reasonable means to establish that otherwise qualified tangible personal property has a useful life of one or more years. And, the lack of specificity creates an ambiguity as to whether it is permissible to use other reasonable methods to substantiate the useful life of otherwise qualified tangible personal property under the statute. The Board also determined that the amendments to California Code of Regulations, title 18, section (Regulation) 1525.4, *Manufacturing and Research & Development Equipment*, requested in the California Taxpayers Association's (CalTax's) petition (discussed in the initial statement of reasons) are reasonably necessary for the specific purpose of addressing the issue created by the ambiguity in the statute by adding clarifying provisions to the regulation expressly permitting taxpayers to substantiate the useful life of otherwise qualified tangible personal property using other reasonable means, including a warranty, service contract, or industry practice.

The Board anticipates that the proposed amendments will benefit qualified persons who deduct, rather than capitalize, the cost of otherwise qualified tangible personal property on their state franchise and income tax returns by clarifying that they may substantiate that such property satisfies the "useful life" requirements for the partial exemption provided by RTC section 6377.1 using a warranty, service contract, or industry practice. The Board anticipates that the proposed amendments will benefit all taxpayers by promoting fairness and helping ensure that similarly situated taxpayers, such as Taxpayer A and Taxpayer B referred to in CalTax's petition, do not receive disparate treatment. The Board also anticipates that the proposed amendments will generally benefit the people of the State of California by helping ensure that the partial exemption provided by RTC section 6377.1 is utilized as originally anticipated by the Legislature and that the statute increases manufacturing and manufacturing jobs in California as the Legislature intended.

The Board has also determined that the proposed amendments to Regulation 1525.4 are fully consistent with current law, including RTC section 6377.1, subject to Office of Administrative Law approval, and there is nothing in the proposed amendments that would significantly change how the Legislature intended for individuals and businesses to behave in response to RTC section 6377.1. Therefore, the Board estimates that the proposed amendments, themselves, 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 amendments to Regulation 1525.4 are 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 amendments 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.

Furthermore, the Board has determined that the proposed amendments to Regulation 1525.4 do not impose any costs on any persons, including businesses, that are not already imposed by RTC section 6377.1, and the Board has determined that there is nothing in the proposed amendments to Regulation 1525.4 that would impact revenue. Therefore, based upon the foregoing

information and all of the information in the rulemaking file, the Board has determined that the adoption of the proposed amendments to 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;
- Will neither create nor eliminate jobs in the State of California nor result in the elimination of existing businesses nor affect the expansion of businesses currently doing business in the State of California;
- Will not have a significant effect on housing costs;
- 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;
- Will result in no direct or indirect cost to any local agency or school district that is required to be reimbursed under part 7 (commencing with section 17500) of division 4 of title 2 of the Government Code, and will result in no other non-discretionary cost or savings imposed on local agencies; and
- Will not impose a mandate on local agencies or school districts, including a mandate that requires state reimbursement under part 7 (commencing with section 17500) of division 4 of title 2 of the Government Code.

In addition, Regulation 1525.4 does 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 the proposed amendments to 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 the proposed amendments to Regulation 1525.4 will not have a significant adverse economic impact on business, including the ability of California businesses to compete with businesses in other states.

The adoption of the proposed amendments to Regulation 1525.4 may affect small businesses.

STATE OF CALIFORNIA—OFFICE OF ADMINISTRATIVE LAW

NOTICE PUBLICATION/REGULATIONS SUBMISSION

(See instructions on reverse)

For use by Secretary of State only

STD. 400 (REV. 01-2013)

OAL FILE NUMBERS	NOTICE FILE NUMBER	REGULATORY ACTION NUMBER	EMERGENCY NUMBER
	Z-2015-0915-10		

For use by Office of Administrative Law (OAL) only

RECEIVED FOR FILING PUBLICATION DATE

SEP 15 '15 SEP 25 '15

Office of Administrative Law

NOTICE | REGULATIONS

AGENCY WITH RULEMAKING AUTHORITY: State Board of Equalization

AGENCY FILE NUMBER (If any)

A. PUBLICATION OF NOTICE (Complete for publication in Notice Register)

1. SUBJECT OF NOTICE	TITLE(S)	FIRST SECTION AFFECTED	2. REQUESTED PUBLICATION DATE
Manufacturing and Research & Development Equip	18	1525.4	September 25, 2015

3. NOTICE TYPE	4. AGENCY CONTACT PERSON	TELEPHONE NUMBER	FAX NUMBER (Optional)
[X] Notice re Proposed Regulatory Action [ ] Other	Richard E. Bennion	(916) 445-2130	(916) 324-3984

OAL USE ONLY	ACTION ON PROPOSED NOTICE	NOTICE REGISTER NUMBER	PUBLICATION DATE
	[ ] Approved as Submitted [ ] Approved as Modified [ ] Disapproved/ Withdrawn		

B. SUBMISSION OF REGULATIONS (Complete when submitting regulations)

1a. SUBJECT OF REGULATION(S)

1b. ALL PREVIOUS RELATED OAL REGULATORY ACTION NUMBER(S)

2. SPECIFY CALIFORNIA CODE OF REGULATIONS TITLE(S) AND SECTION(S) (Including title 26, if toxics related)

SECTION(S) AFFECTED (List all section number(s) individually. Attach additional sheet if needed.)

ADOPT

AMEND

TITLE(S)

REPEAL

3. TYPE OF FILING

- [ ] Regular Rulemaking (Gov. Code §11346)
- [ ] Resubmittal of disapproved or withdrawn nonemergency filing (Gov. Code §§11349.3, 11349.4)
- [ ] Emergency (Gov. Code, §11346.1(b))
- [ ] Certificate of Compliance: The agency officer named below certifies that this agency complied with the provisions of Gov. Code §§11346.2-11347.3 either before the emergency regulation was adopted or within the time period required by statute.
- [ ] Resubmittal of disapproved or withdrawn emergency filing (Gov. Code, §11346.1)
- [ ] Emergency Readopt (Gov. Code, §11346.1(h))
- [ ] File & Print
- [ ] Other (Specify) _____
- [ ] Changes Without Regulatory Effect (Cal. Code Regs., title 1, §100)
- [ ] Print Only

4. ALL BEGINNING AND ENDING DATES OF AVAILABILITY OF MODIFIED REGULATIONS AND/OR MATERIAL ADDED TO THE RULEMAKING FILE (Cal. Code Regs. title 1, §44 and Gov. Code §11347.1)

5. EFFECTIVE DATE OF CHANGES (Gov. Code, §§ 11343.4, 11346.1(d); Cal. Code Regs., title 1, §100)

- [ ] Effective January 1, April 1, July 1, or October 1 (Gov. Code §11343.4(a))
- [ ] Effective on filing with Secretary of State
- [ ] §100 Changes Without Regulatory Effect
- [ ] Effective other (Specify) _____

6. CHECK IF THESE REGULATIONS REQUIRE NOTICE TO, OR REVIEW, CONSULTATION, APPROVAL OR CONCURRENCE BY, ANOTHER AGENCY OR ENTITY

- [ ] Department of Finance (Form STD. 399) (SAM §6660)
- [ ] Fair Political Practices Commission
- [ ] State Fire Marshal
- [ ] Other (Specify) _____

7. CONTACT PERSON	TELEPHONE NUMBER	FAX NUMBER (Optional)	E-MAIL ADDRESS (Optional)

8. **I certify that the attached copy of the regulation(s) is a true and correct copy of the regulation(s) identified on this form, that the information specified on this form is true and correct, and that I am the head of the agency taking this action, or a designee of the head of the agency, and am authorized to make this certification.**

SIGNATURE OF AGENCY HEAD OR DESIGNEE | DATE

TYPED NAME AND TITLE OF SIGNATORY

For use by Office of Administrative Law (OAL) only

TITLE 18. BOARD OF EQUALIZATION

The State Board of Equalization Proposes to Adopt Amendments to 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 amendments to California Code of Regulations, title 18, section (Regulation or Reg.) 1525.4, *Manufacturing and Research & Development Equipment*. The proposed amendments further implement, interpret, and makes specific the "useful life" provisions used in RTC section 6377.1, which provides a 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, by adding clarifying provisions to the regulation expressly permitting taxpayers to substantiate the useful life of otherwise qualified tangible personal property using a warranty, service contract, or industry practice.

PUBLIC HEARING

The Board will conduct a meeting in Room 207 at 5901 Green Valley Circle, Culver City, California, on November 17-19, 2015. 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 9:30 a.m. or as soon thereafter as the matter may be heard on November 17, 18 or 19, 2015. At the hearing, any interested person may present or submit oral or written statements, arguments, or contentions regarding the adoption of the proposed amendments to 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)

<u>Summary of Existing Laws and Regulations</u>

As a general matter, California's Sales and Use Tax Law (Rev. & Tax. Code (RTC), § 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; Reg. 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, § 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; Regs. 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, the composition of the 7.50 percent rate is discussed in the initial statement of reasons, and the combined tax rate is higher than 7.50 percent 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.).

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 exemption provided by RTC section 6377.1, subdivision (a), is referred to as a partial exemption because RTC section 6377.1, subdivision (d), specifies that the 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; and 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.

RTC section 6377.1, subdivision (a), provides that the partial exemption provided by RTC section 6377.1 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.

As relevant here, RTC section 6377.1, subdivision (b)(7), defines the term "qualified tangible personal property," as follows for purposes of the partial exemption:

> (7)(A) "Qualified tangible personal property" includes, but is not limited to, all of the following:
> (i) Machinery and equipment, including component parts and contrivances such as belts, shafts, moving parts, and operating structures.
> (ii) 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.
> (iii) Tangible personal property used in pollution control that meets standards established by this state or any local or regional governmental agency within this state.
> (iv) 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.
> (B) "Qualified tangible personal property" shall not include any of the following:
> (i) Consumables with a useful life of less than one year.
> (ii) 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.
> (iii) Tangible personal property used primarily in administration, general management, or marketing.

As relevant here, RTC section 6377.1, subdivision (b)(10), defines the term "useful life," which is used in the definition of "qualified tangible personal property." Subdivision (b)(10) provides that "'Useful life' for tangible personal property that is treated 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 section. '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 purposes of this section" (hereafter also referred to as the "deemed" provisions of RTC section 6377.1).

Also, as relevant here, the Legislature intended for the partial exemption provided by RTC section 6377.1 to be fully utilized and, to ensure such utilization, RTC section 6377.1, subdivision (g), provides that:

> (g)(1) Upon the effective date of this section, the Department of Finance shall estimate the total dollar amount of exemptions that will be taken for each calendar year, or any portion thereof, for which this section provides an exemption.
> (2) No later than each March 1 next following a calendar year for which this section provides an exemption, the board shall provide to the Joint Legislative Budget Committee a report of the total dollar amount of exemptions taken under this section for the immediately preceding calendar year. The report shall compare the total dollar amount of exemptions taken under this section for that calendar year with the department's estimate for that same calendar year. If that total dollar amount taken is less than the estimate for that calendar year, the report shall identify options for increasing exemptions taken so as to meet estimated amounts.

In addition, the Board adopted Regulation 1525.4 to have the effect and accomplish the objective of fully implementing, interpreting, and making specific the provisions of RTC section 6377.1 on April 22, 2014, and the regulation became effective on September 25, 2014. As relevant here, Regulation 1525.4, subdivision (b)(9), incorporates the definition of "qualified tangible personal property" from RTC section 6377.1, subdivision (b)(7) (with some minor clarifications that are not relevant here). And, Regulation 1525.4, subdivision (b)(13), incorporates the definition of "useful life" from the "deemed" provisions of RTC section 6377.1, and provides as follows:

> (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.

Furthermore, as relevant here, for federal income tax purposes:

- A taxpayer is generally allowed a current deduction, under Internal Revenue Code (IRC) section 162, for the entire cost of tangible personal property used in a trade or business that has a useful life of 12-months or less;

- A taxpayer is allowed to capitalize the cost of tangible personal property that is used in a trade or business and has a useful life of more than 12 months, and a taxpayer is only generally allowed to annually claim a depreciation deduction for part of the cost of the property (or capital asset) as it is exhausted over its useful life, under IRC section 167; and
- A taxpayer also is generally permitted to "elect" to treat the entire cost of tangible personal property used in a trade or business with a useful life of more than 12 months as a current deduction, under IRC section 179, subject to certain limitations that are not relevant here.

Both California's Personal Income Tax Law (RTC, § 17001 et seq.) and Corporation Tax Law (RTC, § 23001 et seq.) either generally incorporate or contain similar provisions to IRC sections 162, 167, and 179. (See, RTC, §§ 17201, 24343, 24349, 24356, subd. (b)(1)). Therefore, for state franchise and income tax purposes, a qualified person (as defined in RTC, § 6377.1) may treat the entire cost of otherwise qualified tangible personal property with a useful life of exactly one year (or 12 months) as a current deduction, under the provisions of IRC section 162 incorporated into or contained in California law, and may either treat all or a part of the cost of otherwise qualified tangible personal property with a useful life of more than one year (or 12 months) as a current deduction, under the provisions of IRC sections 167 and 179 incorporated into or contained in California law.

Effect, Objective, and Benefits of the Proposed Amendments to Regulation 1525.4

Rulemaking Petition

On Tuesday, July 21, 2015, the Board's Legal Department received a petition dated July 21, 2015, from Ms. Teresa Casazza on behalf of the California Taxpayers Association (CalTax), pursuant to Government Code section 11340.6, requesting that the Board amend Regulation 1525.4 to add clarifying language so that taxpayers may substantiate that tangible personal property satisfies the useful life qualification in RTC section 6377.1 by reference to either warranties, maintenance agreements, or industry replacement standards. The petition explained that:

> 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.

The attachment to the petition also specifically recommended that the Board amend Regulation 1525.4, subdivision (b)(13), to read as follows:

(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 [personal] 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.

The Board's Legal Department prepared a Chief Counsel Memorandum dated August 3, 2015, which set forth relevant background information pertaining to the adoption of Regulation 1525.4, provided a discussion of CalTax's petition, and provided Board staff's response. CalTax's petition and Formal Issue Paper 14-001 regarding the Board's adoption of Regulation 1525.4 were also included as attachments to the Chief Counsel Memorandum.

The Chief Counsel Memorandum explained that staff "recognizes that [RTC] 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 [the] '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 [with a useful life of more than one year] 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."

The Chief Counsel Memorandum explained that "CalTax asserts that the explicit language in subdivision (b)(7)(A)(i) makes it clear that the Legislature intended [for the partial exemption to apply to] the component parts and contrivances of machinery and equipment. CalTax further asserts that limiting the [partial] exemption [by narrowly applying] subdivision (b)(10) of that section would needlessly thwart the purpose and intent of RTC section 6377.1."

The Chief Counsel Memorandum also advised the Board, that "[i]f 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, [then,] subject to approval by the Office of Administrative Law [(OAL)], CalTax's requested amendments will address the issues raised by CalTax and effectuate such legislative intent."

August 25, 2015, Board Meeting

The Chief Counsel Memorandum dated August 3, 2015, and CalTax's petition were submitted to the Board Members for consideration during the Board's August 25, 2015, meeting. During the meeting, Board staff introduced the agenda item. Board staff said that, "[a]lthough staff has concerns about the 'deemed' provisions of [RTC] section 6377.1, [staff understands] the perceived ambiguities in the [entire] section's wording and [staff realizes] that reasonable minds may differ on its interpretation." Board staff said that "[i]f the Board agrees, in light of the entire statutory scheme, [that] 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 the approval by [OAL], [Caltax's] proposed amendment[s] will address the issues raised by CalTax and effectuate such legislative intent." Staff also said that staff did not "regard [CalTax's] proposal as having a revenue impact since, subject to the approval by [OAL], [the requested amendments] would be regarded as consistent with the implementing statute." Furthermore, staff said that "for the first year, the [partial] exemption usage was anticipated to be [based on] approximately $15 billion [of expenditures]. However, based upon returns to date, we have [only] seen approximately $3 billion of usage," which may be due to the perceived ambiguities in the statute.

During the discussion of the item, Ms. Therese Twomey, Fiscal Policy Director for CalTax, asked the Board to grant the petition to add the clarifying language to Regulation 1525.4. Ms. Twomey said that "there is ambiguity in the statute," the "ambiguity has prohibited some taxpayers [from qualifying] for the exemption" and, therefore, prevented the partial exemption from generating "the economic activity that was intended by the Legislature" to help increase manufacturing and manufacturing jobs in California. Ms. Twomey also said that CalTax's requested amendments will "allow California taxpayers to better verify and to have the Board substantiate that the 'useful life' language can be substantiated through either a warranty that lasts more than one year, a maintenance contract that lasts more than one year, or industry replacement standards that last for more than one year."

In addition, Ms. Twomey pointed out that RTC section 6377.1, subdivision (g), "itself asks the [Board] to take a look at utilization as well as to compare the utilization to the amount that was estimated, and in the event that that utilization is lower than what is estimated, that the Board make recommendations and pursue changes in order to garner the amount that was initially intended and the economic activity that was intended." She also said that CalTax has "discussed [utilization] with the Department of Finance. And as a matter of fact, they have been asking [CalTax] why utilization is so low" and they are relying on CalTax "to provide the industry's perspective as to why. . . ."

Furthermore, during the discussion of the item, Deputy State Controller Yvette Stowers said that she and State Controller Betty Yee "support having businesses benefit from this exemption and we acknowledge that it is underutilized." However, she also expressed the concern that the useful life requirement "needs to be fixed in the statute first, as opposed to the regulation" and she said "[f]or that fact" she would "not be voting yes to accept the petition."

In response, Board Chairman Jerome Horton agreed with Ms. Stowers that it would be good to have a statutory fix, but he also expressed serious concerns about the underutilization of the partial exemption and the delays associated with solely pursuing a statutory fix. So, Chairman Horton urged the Board to try to fix the situation by amending the regulation as requested by CalTax.

Also, Board Members George Runner, Diane Harkey and Fiona Ma agreed with Chairman Horton that the Board should try to fix the situation by amending the regulation as requested by CalTax. Both Chairman Horton and Board Member Runner expressed their understanding that OAL would serve as a "backstop" if a statutory fix is legally required before the Board can amend the regulation. And, Board Member Ma explained that, based upon her experience in the Legislature, the Legislature does not have the time to specifically address every regulatory issue in proposed legislation, and the Legislature often enacts legislation with the expectation that the implementing agencies will adopt regulations to address specific regulatory issues when necessary.

At the conclusion of the Board discussion of the item, Chairman Horton and Board Members Harkey, Runner, and Ma voted to grant CalTax's petition and propose the requested amendments to Regulation 1525.4. The Board determined that there is an issue because RTC section 6377.1 does not specify whether a qualified person who currently deducts the entire cost of otherwise qualified tangible personal property that actually has a useful life of one or more years is "treating" such property as having a useful life of less than one year or a useful life of one or more years for state franchise and income tax purposes. RTC section 6377.1 does not expressly state that its "deemed" provisions are the exclusive means by which a qualified person may substantiate that otherwise qualified tangible personal property has a useful life of one or more years for purposes of the partial exemption. RTC section 6377.1 does not provide other reasonable means to establish that otherwise qualified tangible personal property has a useful life of one or more years. And, the lack of specificity creates an ambiguity as to whether it is permissible to use other reasonable methods to substantiate the useful life of otherwise qualified tangible personal property under the statute. The Board also determined that the amendments requested in CalTax's petition are reasonably necessary to have the effect and accomplish the objective of addressing the issue created by the ambiguity in the statute by adding clarifying provisions to the regulation expressly permitting taxpayers to substantiate the useful life of otherwise qualified tangible personal property using other reasonable means, including a warranty, service contract, or industry practice.

The Board anticipates that the proposed amendments will benefit qualified persons who deduct, rather than capitalize, the cost of otherwise qualified tangible personal property on their state franchise and income tax returns by clarifying that they may substantiate that such property satisfies the "useful life" requirements for the partial exemption provided by RTC section 6377.1 using a warranty, service contract, or industry practice. The Board anticipates that the proposed amendments will benefit all taxpayers by promoting fairness and helping ensure that similarly situated taxpayers, such as Taxpayer A and Taxpayer B referred to in CalTax's petition, do not receive disparate treatment. The Board also anticipates that the proposed amendments will generally benefit the people of the State of California by helping ensure that the partial exemption provided by RTC section 6377.1 is utilized as originally anticipated by the Legislature and that the statute increases manufacturing and manufacturing jobs in California as the Legislature intended.

The Board has performed an evaluation of whether the proposed amendments to Regulation 1525.4 are inconsistent or incompatible with existing state regulations and determined that the proposed amendments are not inconsistent or incompatible with existing state regulations. This is because Regulation 1525.4 is the only state regulation that specifically implements, interprets, and makes specific the provisions of RTC section 6377.1, and the proposed amendments to Regulation 1525.4 clarify and are consistent with the regulation's current provisions. In addition, the Board has determined that there are no comparable federal regulations or statutes to Regulation 1525.4 or the proposed amendments to Regulation 1525.4.

NO MANDATE ON LOCAL AGENCIES OR SCHOOL DISTRICTS

The Board has determined that the adoption of the proposed amendments to 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 the proposed amendments to 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 the proposed amendments to 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 the proposed amendments to 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.

The adoption of the proposed amendments to Regulation 1525.4 may affect small business.

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 amendments to Regulation 1525.4 are 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 the proposed amendments to 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 the proposed amendments to 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 the proposed amendments to 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 amendments should be directed to Bradley M. Heller, Tax Counsel IV, by telephone at (916) 323-3091, by e-mail at Bradley.Heller@boe.ca.gov, or by mail at State Board of Equalization, Attn: Bradley Heller, 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. Mr. Bennion is the designated backup contact person to Mr. Heller.

WRITTEN COMMENT PERIOD

The written comment period ends at 9:30 a.m. on November 17, 2015, or as soon thereafter as the Board begins the public hearing regarding the proposed amendments to Regulation 1525.4 during the November 17-19, 2015, 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 the proposed amendments to 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 the proposed amendments to Regulation 1525.4 and the additions to the regulation are underlined in the text. The Board has also prepared an initial statement of reasons for the adoption of the proposed amendments to Regulation 1525.4, 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 amendments are 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 amendments 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 the proposed amendments to 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 amendments, with the change clearly indicated, available to the public for at least 15 days before adoption. The text of the proposed amendments, with the change clearly indicated, will be mailed to those interested parties who commented on the original proposed amendments orally or in writing or who asked to be informed of such changes. The text of the proposed amendments, with the change clearly indicated, will also be available to the public from Mr. Bennion. The Board will consider written comments regarding the sufficiently related change that are received prior to the Board's adoption of the resulting regulation.

EFFECTIVE DATE

The Board is proposing to adopt amendments to Regulation 1525.4 to further implement, interpret, and make specific the partial exemption from sales and use tax provided by RTC section 6377.1. The partial exemption became effective on July 1, 2014, and is not

being utilized as anticipated and intended by the Legislature, which may be due to the ambiguity in RTC section 6377.1 that the amendments are intended to clarify. Also, once the proposed amendments are effective, the clarification 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 the proposed clarifying amendments to Regulation 1525.4 in order to help ensure that the partial exemption begins to be utilized as originally anticipated and intended by the Legislature, as soon as possible, and the Board may request an early effective date for the proposed amendments to Regulation 1525.4, pursuant to Government Code section 11343.4, subdivision (b)(3).

AVAILABILITY OF FINAL STATEMENT OF REASONS

If the Board adopts the proposed amendments to 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*.

Bennion, Richard

From: BOE-Board Meeting Material
Sent: Friday, September 25, 2015 7:39 AM
To: Alonzo, Mary Ann (Legal); Angeja, Jeff (Legal); Armenta, Christopher; Asprey, Kathryn E; Bartolo, Lynn; Bennion, Richard; Benson, Bill; Bisauta, Christine (Legal); Blake, Sue; Block, Susan; BOE-Board Meeting Material; Bridges, Cynthia; Brown, Michele C; Chung, Sophia (Legal); Cruz, Giovan; Davis, Toya P.; Dixon, Camille; Duran, David; Durham, Mark; Epolite, Anthony (Legal); Ferris, Randy (Legal); Folchi, Gino; Ford, Ladeena L; Garcia, Laura; Gau, David; Gilman, Todd; Grant, Micah; Hamilton, Tabitha; Harrison, Michelle; Harvill, Mai; Heller, Bradley (Legal); Hellmuth, Leila; Herrera, Cristina; Hite, Jay; Holmes, Dana; Hughes, Shellie L; Huxsoll, Cary; Jacobson, Andrew; Kinkle, Sherrie L; Kinst, Lynne; Kuhl, James; Lambert, Gary; Lambert, Robert (Legal); Lee, Chris; Levine, David H. (Legal); Lopez, Claudia; Lowery, Russell; Matsumoto, Sid; Matthies, Ted; McElhinney, Andrew; McGuire, Jeff; Miller, Brad; Moon, Richard (Legal); Nienow, Trecia (Legal); Oakes, Clifford; Pielsticker, Michele; Ralston Ratcliff, Natasha; Renati, Lisa; Richmond, Joann; Riley, Denise (Legal); Romano, Dario; Salazar, Ramon; Sarcos, Eric; Schultz, Glenna; Silva, Monica (Legal); Singh, Sam; Smith, Kevin (Legal); Smith, Rose; Stowers, Yvette; Tran, Mai (Legal); Treichelt, Tim; Tucker, Robert (Legal); Vandrick, Tanya; Vena, Emily (Legal); Wallentine, Sean; Whitaker, Lynn; White, Sharon; Wiggins, Brian; Williams, Lee; Zivkovich, Robert; Zumaeta, Jaclyn
Subject: State Board of Equalization - Announcement of Regulatory Change to Regulation 1525.4

The State Board of Equalization proposes to adopt amendments to Sales and Use Tax Regulation 1525.4, *Manufacturing and Research & Development Equipment*, to clarifying that taxpayers may substantiate the useful life of otherwise qualified tangible personal property using a warranty, service contract, or industry practice. A public hearing regarding the proposed amendments will be held in Room 207, 5901 Green Valley Circle, Culver City, at 9:30 a.m., or as soon thereafter as the matter may be heard, on November 17-19, 2015.

To view the notice of hearing, initial statement of reasons, proposed text, and history click on the following link: http://www.boe.ca.gov/regs/reg_1525_4_2015.htm.

Questions regarding the substance of the proposed amendments should be directed to Mr. Bradley Heller, Tax Counsel IV, at 450 N Street, MIC:82, Sacramento, CA 94279-0082, email Bradley.Heller@boe.ca.gov, telephone (916) 323-3091, or FAX (916) 323-3387.

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

Please do not reply to this message.

Board Proceedings Division, MIC:80
Rick Bennion
Regulations Coordinator
Phone (916) 445-2130
Fax (916) 324-3984
Richard.Bennion@boe.ca.gov

Bennion, Richard

From: State Board of Equalization - Announcement of Regulatory Change <Legal.Regulations@BOE.CA.GOV>
Sent: Friday, September 25, 2015 8:51 AM
To: BOE_REGULATIONS@LISTSERV.STATE.CA.GOV
Subject: State Board of Equalization - Announcement of Regulatory Change 1525.4

The State Board of Equalization proposes to adopt amendments to Sales and Use Tax Regulation 1525.4, *Manufacturing and Research & Development Equipment*, to clarifying that taxpayers may substantiate the useful life of otherwise qualified tangible personal property using a warranty, service contract, or industry practice. A public hearing regarding the proposed amendments will be held in Room 207, 5901 Green Valley Circle, Culver City, at 9:30 a.m., or as soon thereafter as the matter may be heard, on November 17-19, 2015.

To view the notice of hearing, initial statement of reasons, proposed text, and history click on the following link: http://www.boe.ca.gov/regs/reg_1525_4_2015.htm .

Questions regarding the substance of the proposed amendments should be directed to Mr. Bradley Heller, Tax Counsel IV, at 450 N Street, MIC:82, Sacramento, CA 94279-0082, email Bradley.Heller@boe.ca.gov, telephone (916) 323-3091, or FAX (916) 323-3387.

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

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sing the Board of Pharmacy's website at http://www.pharmacy.ca.gov.

CONTACT PERSON

Materials regarding this proposal can be found at www.pharmacy.ca.gov. Inquiries or comments concerning the proposed rulemaking actions may be addressed to:

Board of Pharmacy
Attn: Lori Martinez
1625 N. Market Blvd., N219
Sacramento, CA 95834
Telephone: 916–574–7917
Fax No.: 916–574–8618
E–Mail: Lori.Martinez@dca.ca.gov

(Backup contact person)

Board of Pharmacy
Attn: Anne Sodergren
1625 N. Market Blvd., N219
Sacramento, CA 95834
Telephone: 916–574–7910
Fax No.: 916–574–8618
E–Mail: Anne.Sodergren@dca.ca.gov

TITLE 18. BOARD OF EQUALIZATION

The State Board of Equalization Proposes to Adopt Amendments to California Code of Regulations, Title 18, Section1525.4, *Manufacturing and Research and 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 amendments to California Code of Regulations, title 18, section (Regulation or Reg.) 1525.4, *Manufacturing and Research and Development Equipment.* The proposed amendments further implement, interpret, and makes specific the "useful life" provisions used in RTC section 6377.1, which provides a 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, by adding clarifying provisions to the regulation expressly permitting taxpayers to substantiate the useful life of otherwise qualified tangible personal property using a warranty, service contract, or industry practice.

PUBLIC HEARING

The Board will conduct a meeting in Room 207 at 5901 Green Valley Circle, Culver City, California, on November 17–19, 2015. 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 9:30 a.m. or as soon thereafter as the matter may be heard on November 17, 18 or 19, 2015. At the hearing, any interested person may present or submit oral or written statements, arguments, or contentions regarding the adoption of the proposed amendments to 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 (Rev. & Tax. Code, § 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; Reg. 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, § 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; Regs. 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, the composition of the 7.50 percent rate is discussed in the initial statement of reasons, and the combined tax rate is higher than 7.50 percent 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.).

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 purchases made on and after July 1, 2014, and before July 1, 2022. The exemption provided by RTC section 6377.1, subdivision (a), is referred to as a partial exemption because RTC section 6377.1, subdivision (d), specifies that the 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; and 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.

RTC section 6377.1, subdivision (a), provides that the partial exemption provided by RTC section 6377.1 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.

As relevant here, RTC section 6377.1, subdivision (b)(7), defines the term "qualified tangible personal property," as follows for purposes of the partial exemption:

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

(i) Machinery and equipment, including component parts and contrivances such as belts, shafts, moving parts, and operating structures.

(ii) 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.

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

(iv) 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.

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

(i) Consumables with a useful life of less than one year.

(ii) 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.

(iii) Tangible personal property used primarily in administration, general management, or marketing.

As relevant here, RTC section 6377.1, subdivision (b)(10), defines the term "useful life," which is used in the definition of "qualified tangible personal property." Subdivision (b)(10) provides that "'Useful life' for tangible personal property that is treated 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 section. '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 purposes of this section" (hereafter also referred to as the "deemed" provisions of RTC section 6377.1).

Also, as relevant here, the Legislature intended for the partial exemption provided by RTC section 6377.1 to be fully utilized and, to ensure such utilization, RTC section 6377.1, subdivision (g), provides that:

> (g)(1) Upon the effective date of this section, the Department of Finance shall estimate the total dollar amount of exemptions that will be taken for each calendar year, or any portion thereof, for which this section provides an exemption.
>
> (2) No later than each March 1 next following a calendar year for which this section provides an exemption, the board shall provide to the Joint Legislative Budget Committee a report of the total dollar amount of exemptions taken under this section for the immediately preceding calendar year. The report shall compare the total dollar amount of exemptions taken under this section for that calendar year with the department's estimate for that same calendar year. If that total dollar amount taken is less than the estimate for that calendar year, the report shall identify options for increasing exemptions taken so as to meet estimated amounts.

In addition, the Board adopted Regulation 1525.4 to have the effect and accomplish the objective of fully implementing, interpreting, and making specific the provisions of RTC section 6377.1 on April 22, 2014, and the regulation became effective on September 25, 2014. As relevant here, Regulation 1525.4, subdivision (b)(9), incorporates the definition of "qualified tangible personal property" from RTC section 6377.1, subdivision (b)(7) (with some minor clarifications that are not relevant here). And, Regulation 1525.4, subdivision (b)(13), incorporates the definition of "useful life" from the "deemed" provisions of RTC section 6377.1, and provides as follows:

> (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.

Furthermore, as relevant here, for federal income tax purposes:

- A taxpayer is generally allowed a current deduction, under Internal Revenue Code (IRC) section 162, for the entire cost of tangible personal property used in a trade or business that has a useful life of 12 months or less;
- A taxpayer is allowed to capitalize the cost of tangible personal property that is used in a trade or business and has a useful life of more than 12 months, and a taxpayer is only generally allowed to annually claim a depreciation deduction for part of the cost of the property (or capital asset) as it is exhausted over its useful life, under IRC section 167; and
- A taxpayer also is generally permitted to "elect" to treat the entire cost of tangible personal property used in a trade or business with a useful life of more than 12 months as a current deduction, under IRC section 179, subject to certain limitations that are not relevant here.

Both California's Personal Income Tax Law (RTC, § 17001 et seq.) and Corporation Tax Law (RTC, § 23001 et seq.) either generally incorporate or contain similar provisions to IRC sections 162, 167, and 179. (See, RTC, §§ 17201, 24343, 24349, 24356, subd. (b)(1)). Therefore, for state franchise and income tax purposes, a qualified person (as defined in RTC, § 6377.1) may treat the entire cost of otherwise qualified tangible personal property with a useful life of exactly one year (or 12 months) as a current deduction, under the provisions of IRC section 162 incorporated into or contained in California law, and may either treat all or a part of the cost of otherwise qualified tangible personal property with a useful life of more than one year (or 12 months) as a current deduction, under the provisions of IRC sections 167 and 179 incorporated into or contained in California law.

Effect, Objective, and Benefits of the Proposed Amendments to Regulation 1525.4

Rulemaking Petition

On Tuesday, July 21, 2015, the Board's Legal Department received a petition dated July 21, 2015, from Ms. Teresa Casazza on behalf of the California Taxpayers Association (CalTax), pursuant to Government Code section 11340.6, requesting that the Board amend Regulation 1525.4 to add clarifying language so that taxpayers may substantiate that tangible personal property satisfies the useful life qualification in RTC section 6377.1 by reference to either warranties, maintenance agreements, or industry replacement standards. The petition explained that:

> 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.

The attachment to the petition also specifically recommended that the Board amend Regulation 1525.4, subdivision (b)(13), to read as follows:

(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 [personal] 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.

Chief Counsel Memorandum

The Board's Legal Department prepared a Chief Counsel Memorandum dated August 3, 2015, which set forth relevant background information pertaining to the adoption of Regulation 1525.4, provided a discussion of CalTax's petition, and provided Board staff's response. CalTax's petition and Formal Issue Paper 14–001 regarding the Board's adoption of Regulation 1525.4 were also included as attachments to the Chief Counsel Memorandum.

The Chief Counsel Memorandum explained that staff "recognizes that [RTC] 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 [the] '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 [with a useful life of more than one year] 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."

The Chief Counsel Memorandum explained that "CalTax asserts that the explicit language in subdivision (b)(7)(A)(i) makes it clear that the Legislature intended [for the partial exemption to apply to] the component parts and contrivances of machinery and equipment. CalTax further asserts that limiting the [partial] exemption [by narrowly applying] subdivision (b)(10) of that section would needlessly thwart the purpose and intent of RTC section 6377.1."

The Chief Counsel Memorandum also advised the Board, that "[i]f 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, [then,] subject to approval by the Office of Administrative Law [OAL], CalTax's requested amendments will address the issues raised by CalTax and effectuate such legislative intent."

August 25, 2015, Board Meeting

The Chief Counsel Memorandum dated August 3, 2015, and CalTax's petition were submitted to the Board Members for consideration during the Board's August 25, 2015, meeting. During the meeting, Board staff introduced the agenda item. Board staff said that, "[a]lthough staff has concerns about the 'deemed' provisions of [RTC] section 6377.1, [staff understands] the perceived ambiguities in the [entire] section's wording and [staff realizes] that reasonable minds may differ on its interpretation." Board staff said that "[i]f the Board agrees, in light of the entire statutory scheme, [that] 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 the approval by [OAL], [CalTax's] proposed amendment[s] will address the issues raised by CalTax and effectuate such legislative intent." Staff also said that staff did not "regard [CalTax's] proposal as having a revenue impact since, subject to the approval by [OAL], [the requested amendments] would be regarded as consistent with the implementing statute." Furthermore, staff said that "for the first year, the [partial] exemption usage was anticipated to be [based on] approximately $15 billion [of expenditures]. However, based upon returns to date, we have [only] seen approximately $3 billion of usage," which may be due to the perceived ambiguities in the statute.

During the discussion of the item, Ms. Therese Twomey, Fiscal Policy Director for CalTax, asked the Board to grant the petition to add the clarifying language to Regulation 1525.4. Ms. Twomey said that "there is ambiguity in the statute," the "ambiguity has prohibited some taxpayers [from qualifying] for the exemption" and, therefore, prevented the partial exemption from generating "the economic activity that was intended by the Legislature" to help increase manufacturing and manufacturing jobs in California. Ms. Twomey also said that CalTax's requested amendments will "allow California taxpayers to better verify and to have the Board substantiate that the 'useful life' language can be substantiated through either a warranty that lasts more than one year, a maintenance contract that lasts more than one year, or industry replacement standards that last for more than one year."

In addition, Ms. Twomey pointed out that RTC section 6377.1, subdivision (g), "itself asks the [Board] to

take a look at utilization as well as to compare the utilization to the amount that was estimated, and in the event that that utilization is lower than what is estimated, that the Board make recommendations and pursue changes in order to garner the amount that was initially intended and the economic activity that was intended." She also said that CalTax has "discussed [utilization] with the Department of Finance. And as a matter of fact, they have been asking [CalTax] why utilization is so low" and they are relying on CalTax "to provide the industry's perspective as to why. . . ."

Furthermore, during the discussion of the item, Deputy State Controller Yvette Stowers said that she and State Controller Betty Yee "support having businesses benefit from this exemption and we acknowledge that it is underutilized." However, she also expressed the concern that the useful life requirement "needs to be fixed in the statute first, as opposed to the regulation" and she said "[f]or that fact" she would "not be voting yes to accept the petition."

In response, Board Chairman Jerome Horton agreed with Ms. Stowers that it would be good to have a statutory fix, but he also expressed serious concerns about the underutilization of the partial exemption and the delays associated with solely pursuing a statutory fix. So, Chairman Horton urged the Board to try to fix the situation by amending the regulation as requested by CalTax.

Also, Board Members George Runner, Diane Harkey and Fiona Ma agreed with Chairman Horton that the Board should try to fix the situation by amending the regulation as requested by CalTax. Both Chairman Horton and Board Member Runner expressed their understanding that OAL would serve as a "backstop" if a statutory fix is legally required before the Board can amend the regulation. And, Board Member Ma explained that, based upon her experience in the Legislature, the Legislature does not have the time to specifically address every regulatory issue in proposed legislation, and the Legislature often enacts legislation with the expectation that the implementing agencies will adopt regulations to address specific regulatory issues when necessary.

At the conclusion of the Board discussion of the item, Chairman Horton and Board Members Harkey, Runner, and Ma voted to grant CalTax's petition and propose the requested amendments to Regulation 1525.4. The Board determined that there is an issue because RTC section 6377.1 does not specify whether a qualified person who currently deducts the entire cost of otherwise qualified tangible personal property that actually has a useful life of one or more years is "treating" such property as having a useful life of less than one year or a useful life of one or more years for state franchise and income tax purposes. RTC section 6377.1 does not expressly state that its "deemed" provisions are the exclusive means by which a qualified person may substantiate that otherwise qualified tangible personal property has a useful life of one or more years for purposes of the partial exemption. RTC section 6377.1 does not provide other reasonable means to establish that otherwise qualified tangible personal property has a useful life of one or more years. And, the lack of specificity creates an ambiguity as to whether it is permissible to use other reasonable methods to substantiate the useful life of otherwise qualified tangible personal property under the statute. The Board also determined that the amendments requested in CalTax's petition are reasonably necessary to have the effect and accomplish the objective of addressing the issue created by the ambiguity in the statute by adding clarifying provisions to the regulation expressly permitting taxpayers to substantiate the useful life of otherwise qualified tangible personal property using other reasonable means, including a warranty, service contract, or industry practice.

The Board anticipates that the proposed amendments will benefit qualified persons who deduct, rather than capitalize, the cost of otherwise qualified tangible personal property on their state franchise and income tax returns by clarifying that they may substantiate that such property satisfies the "useful life" requirements for the partial exemption provided by RTC section 6377.1 using a warranty, service contract, or industry practice. The Board anticipates that the proposed amendments will benefit all taxpayers by promoting fairness and helping ensure that similarly situated taxpayers, such as Taxpayer A and Taxpayer B referred to in CalTax's petition, do not receive disparate treatment. The Board also anticipates that the proposed amendments will generally benefit the people of the State of California by helping ensure that the partial exemption provided by RTC section 6377.1 is utilized as originally anticipated by the Legislature and that the statute increases manufacturing and manufacturing jobs in California as the Legislature intended.

The Board has performed an evaluation of whether the proposed amendments to Regulation 1525.4 are inconsistent or incompatible with existing state regulations and determined that the proposed amendments are not inconsistent or incompatible with existing state regulations. This is because Regulation 1525.4 is the only state regulation that specifically implements, interprets, and makes specific the provisions of RTC section 6377.1, and the proposed amendments to Regulation 1525.4 clarify and are consistent with the regulation's current provisions. In addition, the Board has determined that there are no comparable federal regulations or statutes to Regulation 1525.4 or the proposed amendments to Regulation 1525.4.

NO MANDATE ON LOCAL AGENCIES OR SCHOOL DISTRICTS

The Board has determined that the adoption of the proposed amendments to 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 the proposed amendments to 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 the proposed amendments to 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 the proposed amendments to 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.

The adoption of the proposed amendments to Regulation 1525.4 may affect small business.

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 amendments to Regulation 1525.4 are 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 the proposed amendments to 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 the proposed amendments to 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 the proposed amendments to 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 amendments should be directed to Bradley M. Heller, Tax Counsel IV, by telephone at (916) 323–3091, by e–mail at Bradley.Heller@boe.ca.gov, or by mail at State Board of Equalization, Attn: Bradley Heller, 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. Mr. Bennion is the designated backup contact person to Mr. Heller.

WRITTEN COMMENT PERIOD

The written comment period ends at 9:30 a.m. on November 17, 2015, or as soon thereafter as the Board begins the public hearing regarding the proposed amendments to Regulation 1525.4 during the November 17–19, 2015, 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 the proposed amendments to 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 the proposed amendments to Regulation 1525.4 and the additions to the regulation are underlined in the text. The Board has also prepared an initial statement of reasons for the adoption of the proposed amendments to Regulation 1525.4, 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 amendments are 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 amendments 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 the proposed amendments to 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 amendments, with the change clearly indicated, available to the public for at least 15 days before adoption. The text of the proposed amendments, with the change clearly indicated, will be mailed to those interested parties who commented on the original proposed amendments orally or in writing or who asked to be informed of such changes. The text of the proposed amendments, with the change clearly indicated, will also be available to the public from Mr. Bennion. The Board will consider written comments regarding the sufficiently related changes that are received prior to the Board's adoption of the resulting regulation.

EFFECTIVE DATE

The Board is proposing to adopt amendments to Regulation 1525.4 to further implement, interpret, and make specific the partial exemption from sales and use tax provided by RTC section 6377.1. The partial exemption became effective on July 1, 2014, and is not being utilized as anticipated and intended by the Legislature, which may be due to the ambiguity in RTC section 6377.1 that the amendments are intended to clarify. Also, once the proposed amendments are effective, the clarification 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 the proposed clarifying amendments to Regulation 1525.4 in order to help ensure that the partial exemption begins to be utilized as originally anticipated and intended by the Legislature, as soon as possible, and the Board may request an early effective date for the proposed amendments to Regulation 1525.4, pursuant to Government Code section 11343.4, subdivision (b)(3).

AVAILABILITY OF FINAL STATEMENT OF REASONS

If the Board adopts the proposed amendments to 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.

STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION
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Fourth District, Orange County

BETTY T. YEE
State Controller

CYNTHIA BRIDGES
Executive Director

September 25, 2015

To Interested Parties:

Notice of Proposed Regulatory Action

The State Board of Equalization Proposes to Adopt Amendments to 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 amendments to California Code of Regulations, title 18, section (Regulation or Reg.) 1525.4, *Manufacturing and Research & Development Equipment*. The proposed amendments further implement, interpret, and makes specific the "useful life" provisions used in RTC section 6377.1, which provides a 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, by adding clarifying provisions to the regulation expressly permitting taxpayers to substantiate the useful life of otherwise qualified tangible personal property using a warranty, service contract, or industry practice.

PUBLIC HEARING

The Board will conduct a meeting in Room 207 at 5901 Green Valley Circle, Culver City, California, on November 17-19, 2015. 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 9:30 a.m. or as soon thereafter as the matter may be heard on November 17, 18 or 19, 2015. At the hearing, any

interested person may present or submit oral or written statements, arguments, or contentions regarding the adoption of the proposed amendments to 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 (Rev. & Tax. Code (RTC), § 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; Reg. 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, § 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; Regs. 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, the composition of the 7.50 percent rate is discussed in the initial statement of reasons, and the combined tax rate is higher than 7.50 percent 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.).

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 exemption provided by RTC section 6377.1, subdivision (a), is referred to as a partial exemption because RTC section 6377.1, subdivision (d), specifies that the 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; and 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.

RTC section 6377.1, subdivision (a), provides that the partial exemption provided by RTC section 6377.1 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.

As relevant here, RTC section 6377.1, subdivision (b)(7), defines the term "qualified tangible personal property," as follows for purposes of the partial exemption:

> (7)(A) "Qualified tangible personal property" includes, but is not limited to, all of the following:
> (i) Machinery and equipment, including component parts and contrivances such as belts, shafts, moving parts, and operating structures.
> (ii) 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.
> (iii) Tangible personal property used in pollution control that meets standards established by this state or any local or regional governmental agency within this state.
> (iv) 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.
> (B) "Qualified tangible personal property" shall not include any of the following:

> (i) Consumables with a useful life of less than one year.
> (ii) 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.
> (iii) Tangible personal property used primarily in administration, general management, or marketing.

As relevant here, RTC section 6377.1, subdivision (b)(10), defines the term "useful life," which is used in the definition of "qualified tangible personal property." Subdivision (b)(10) provides that "'Useful life' for tangible personal property that is treated 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 section. '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 purposes of this section" (hereafter also referred to as the "deemed" provisions of RTC section 6377.1).

Also, as relevant here, the Legislature intended for the partial exemption provided by RTC section 6377.1 to be fully utilized and, to ensure such utilization, RTC section 6377.1, subdivision (g), provides that:

> (g)(1) Upon the effective date of this section, the Department of Finance shall estimate the total dollar amount of exemptions that will be taken for each calendar year, or any portion thereof, for which this section provides an exemption.
> (2) No later than each March 1 next following a calendar year for which this section provides an exemption, the board shall provide to the Joint Legislative Budget Committee a report of the total dollar amount of exemptions taken under this section for the immediately preceding calendar year. The report shall compare the total dollar amount of exemptions taken under this section for that calendar year with the department's estimate for that same calendar year. If that total dollar amount taken is less than the estimate for that calendar year, the report shall identify options for increasing exemptions taken so as to meet estimated amounts.

In addition, the Board adopted Regulation 1525.4 to have the effect and accomplish the objective of fully implementing, interpreting, and making specific the provisions of RTC section 6377.1 on April 22, 2014, and the regulation became effective on September 25, 2014. As relevant here, Regulation 1525.4, subdivision (b)(9), incorporates the definition of "qualified tangible personal property" from RTC section 6377.1, subdivision (b)(7) (with some minor clarifications that are not relevant here). And, Regulation 1525.4, subdivision (b)(13), incorporates the definition of "useful life" from the "deemed" provisions of RTC section 6377.1, and provides as follows:

> (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.

Furthermore, as relevant here, for federal income tax purposes:

- A taxpayer is generally allowed a current deduction, under Internal Revenue Code (IRC) section 162, for the entire cost of tangible personal property used in a trade or business that has a useful life of 12-months or less;
- A taxpayer is allowed to capitalize the cost of tangible personal property that is used in a trade or business and has a useful life of more than 12 months, and a taxpayer is only generally allowed to annually claim a depreciation deduction for part of the cost of the property (or capital asset) as it is exhausted over its useful life, under IRC section 167; and
- A taxpayer also is generally permitted to "elect" to treat the entire cost of tangible personal property used in a trade or business with a useful life of more than 12 months as a current deduction, under IRC section 179, subject to certain limitations that are not relevant here.

Both California's Personal Income Tax Law (RTC, § 17001 et seq.) and Corporation Tax Law (RTC, § 23001 et seq.) either generally incorporate or contain similar provisions to IRC sections 162, 167, and 179. (See, RTC, §§ 17201, 24343, 24349, 24356, subd. (b)(1)). Therefore, for state franchise and income tax purposes, a qualified person (as defined in RTC, § 6377.1) may treat the entire cost of otherwise qualified tangible personal property with a useful life of exactly one year (or 12 months) as a current deduction, under the provisions of IRC section 162 incorporated into or contained in California law, and may either treat all or a part of the cost of otherwise qualified tangible personal property with a useful life of more than one year (or 12 months) as a current deduction, under the provisions of IRC sections 167 and 179 incorporated into or contained in California law.

<u>Effect, Objective, and Benefits of the Proposed Amendments to Regulation 1525.4</u>

Rulemaking Petition

On Tuesday, July 21, 2015, the Board's Legal Department received a petition dated July 21, 2015, from Ms. Teresa Casazza on behalf of the California Taxpayers Association (CalTax), pursuant to Government Code section 11340.6, requesting that the Board amend Regulation 1525.4 to add clarifying language so that taxpayers may substantiate that tangible personal property satisfies the useful life qualification in RTC section 6377.1 by reference to either warranties, maintenance agreements, or industry replacement standards. The petition explained that:

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.

The attachment to the petition also specifically recommended that the Board amend Regulation 1525.4, subdivision (b)(13), to read as follows:

(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 [personal] 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.

Chief Counsel Memorandum

The Board's Legal Department prepared a Chief Counsel Memorandum dated August 3, 2015, which set forth relevant background information pertaining to the adoption of Regulation 1525.4, provided a discussion of CalTax's petition, and provided Board staff's response. CalTax's petition and Formal Issue Paper 14-001 regarding the Board's adoption of Regulation 1525.4 were also included as attachments to the Chief Counsel Memorandum.

The Chief Counsel Memorandum explained that staff "recognizes that [RTC] 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 [the] '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 [with a useful life of more than one year] 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."

The Chief Counsel Memorandum explained that "CalTax asserts that the explicit language in subdivision (b)(7)(A)(i) makes it clear that the Legislature intended [for the partial exemption to apply to] the component parts and contrivances of machinery and equipment. CalTax further asserts that limiting the [partial] exemption [by narrowly applying] subdivision (b)(10) of that section would needlessly thwart the purpose and intent of RTC section 6377.1."

The Chief Counsel Memorandum also advised the Board, that "[i]f 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, [then,] subject to approval by the Office of Administrative Law [(OAL)], CalTax's requested amendments will address the issues raised by CalTax and effectuate such legislative intent."

August 25, 2015, Board Meeting

The Chief Counsel Memorandum dated August 3, 2015, and CalTax's petition were submitted to the Board Members for consideration during the Board's August 25, 2015, meeting. During the meeting, Board staff introduced the agenda item. Board staff said that, "[a]lthough staff has concerns about the 'deemed' provisions of [RTC] section 6377.1, [staff understands] the perceived ambiguities in the [entire] section's wording and [staff realizes] that reasonable minds may differ on its interpretation." Board staff said that "[i]f the Board agrees, in light of the entire statutory scheme, [that] 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 the approval by [OAL], [Caltax's] proposed amendment[s] will address the issues raised by CalTax and effectuate such legislative intent." Staff also said that staff did not "regard [CalTax's] proposal as having a revenue impact since, subject to the approval by [OAL], [the requested amendments] would be regarded as consistent with the implementing statute." Furthermore, staff said that "for the first year, the [partial] exemption usage was anticipated to be [based on] approximately $15 billion [of expenditures]. However, based upon returns to date, we have [only] seen approximately $3 billion of usage," which may be due to the perceived ambiguities in the statute.

During the discussion of the item, Ms. Therese Twomey, Fiscal Policy Director for CalTax, asked the Board to grant the petition to add the clarifying language to Regulation 1525.4. Ms. Twomey said that "there is ambiguity in the statute," the "ambiguity has prohibited some taxpayers [from qualifying] for the exemption" and, therefore, prevented the partial exemption from generating "the economic activity that was intended by the Legislature" to help increase manufacturing and manufacturing jobs in California. Ms. Twomey also said that CalTax's requested amendments will "allow California taxpayers to better verify and to have the Board substantiate that the 'useful life' language can be substantiated through either a warranty that lasts more than one year, a maintenance contract that lasts more than one year, or industry replacement standards that last for more than one year."

In addition, Ms. Twomey pointed out that RTC section 6377.1, subdivision (g), "itself asks the [Board] to take a look at utilization as well as to compare the utilization to the amount that was estimated, and in the event that that utilization is lower than what is estimated, that the Board make recommendations and pursue changes in order to garner the amount that was initially intended and the economic activity that was intended." She also said that CalTax has "discussed [utilization] with the Department of Finance. And as a matter of fact, they have been asking [CalTax] why utilization is so low" and they are relying on CalTax "to provide the industry's perspective as to why. . . ."

Furthermore, during the discussion of the item, Deputy State Controller Yvette Stowers said that she and State Controller Betty Yee "support having businesses benefit from this exemption and we acknowledge that it is underutilized." However, she also expressed the concern that the

useful life requirement "needs to be fixed in the statute first, as opposed to the regulation" and she said "[f]or that fact" she would "not be voting yes to accept the petition."

In response, Board Chairman Jerome Horton agreed with Ms. Stowers that it would be good to have a statutory fix, but he also expressed serious concerns about the underutilization of the partial exemption and the delays associated with solely pursuing a statutory fix. So, Chairman Horton urged the Board to try to fix the situation by amending the regulation as requested by CalTax.

Also, Board Members George Runner, Diane Harkey and Fiona Ma agreed with Chairman Horton that the Board should try to fix the situation by amending the regulation as requested by CalTax. Both Chairman Horton and Board Member Runner expressed their understanding that OAL would serve as a "backstop" if a statutory fix is legally required before the Board can amend the regulation. And, Board Member Ma explained that, based upon her experience in the Legislature, the Legislature does not have the time to specifically address every regulatory issue in proposed legislation, and the Legislature often enacts legislation with the expectation that the implementing agencies will adopt regulations to address specific regulatory issues when necessary.

At the conclusion of the Board discussion of the item, Chairman Horton and Board Members Harkey, Runner, and Ma voted to grant CalTax's petition and propose the requested amendments to Regulation 1525.4. The Board determined that there is an issue because RTC section 6377.1 does not specify whether a qualified person who currently deducts the entire cost of otherwise qualified tangible personal property that actually has a useful life of one or more years is "treating" such property as having a useful life of less than one year or a useful life of one or more years for state franchise and income tax purposes. RTC section 6377.1 does not expressly state that its "deemed" provisions are the exclusive means by which a qualified person may substantiate that otherwise qualified tangible personal property has a useful life of one or more years for purposes of the partial exemption. RTC section 6377.1 does not provide other reasonable means to establish that otherwise qualified tangible personal property has a useful life of one or more years. And, the lack of specificity creates an ambiguity as to whether it is permissible to use other reasonable methods to substantiate the useful life of otherwise qualified tangible personal property under the statute. The Board also determined that the amendments requested in CalTax's petition are reasonably necessary to have the effect and accomplish the objective of addressing the issue created by the ambiguity in the statute by adding clarifying provisions to the regulation expressly permitting taxpayers to substantiate the useful life of otherwise qualified tangible personal property using other reasonable means, including a warranty, service contract, or industry practice.

The Board anticipates that the proposed amendments will benefit qualified persons who deduct, rather than capitalize, the cost of otherwise qualified tangible personal property on their state franchise and income tax returns by clarifying that they may substantiate that such property satisfies the "useful life" requirements for the partial exemption provided by RTC section 6377.1 using a warranty, service contract, or industry practice. The Board anticipates that the proposed

amendments will benefit all taxpayers by promoting fairness and helping ensure that similarly situated taxpayers, such as Taxpayer A and Taxpayer B referred to in CalTax's petition, do not receive disparate treatment. The Board also anticipates that the proposed amendments will generally benefit the people of the State of California by helping ensure that the partial exemption provided by RTC section 6377.1 is utilized as originally anticipated by the Legislature and that the statute increases manufacturing and manufacturing jobs in California as the Legislature intended.

The Board has performed an evaluation of whether the proposed amendments to Regulation 1525.4 are inconsistent or incompatible with existing state regulations and determined that the proposed amendments are not inconsistent or incompatible with existing state regulations. This is because Regulation 1525.4 is the only state regulation that specifically implements, interprets, and makes specific the provisions of RTC section 6377.1, and the proposed amendments to Regulation 1525.4 clarify and are consistent with the regulation's current provisions. In addition, the Board has determined that there are no comparable federal regulations or statutes to Regulation 1525.4 or the proposed amendments to Regulation 1525.4.

NO MANDATE ON LOCAL AGENCIES OR SCHOOL DISTRICTS

The Board has determined that the adoption of the proposed amendments to 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 the proposed amendments to 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 the proposed amendments to 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 the proposed amendments to 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.

The adoption of the proposed amendments to Regulation 1525.4 may affect small business.

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 amendments to Regulation 1525.4 are 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 the proposed amendments to 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 the proposed amendments to 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 the proposed amendments to 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 amendments should be directed to Bradley M. Heller, Tax Counsel IV, by telephone at (916) 323-3091, by e-mail at Bradley.Heller@boe.ca.gov, or by mail at State Board of Equalization, Attn: Bradley Heller, 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. Mr. Bennion is the designated backup contact person to Mr. Heller.

WRITTEN COMMENT PERIOD

The written comment period ends at 9:30 a.m. on November 17, 2015, or as soon thereafter as the Board begins the public hearing regarding the proposed amendments to Regulation 1525.4 during the November 17-19, 2015, 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 the proposed amendments to 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 the proposed amendments to Regulation 1525.4 and the additions to the regulation are underlined in the text. The Board has also prepared an initial statement of reasons for the adoption of the proposed amendments to Regulation 1525.4, 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 amendments are 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 amendments 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 the proposed amendments to 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 amendments, with the change clearly indicated, available to the public for at least 15 days before adoption. The text of the proposed amendments, with the change clearly indicated, will be mailed to those interested parties who commented on the original proposed amendments orally or in writing or who asked to be informed of such changes. The text of the proposed amendments, with the change clearly indicated, will also be available to the public from Mr. Bennion. The Board will consider written comments regarding the

sufficiently related change that are received prior to the Board's adoption of the resulting regulation.

EFFECTIVE DATE

The Board is proposing to adopt amendments to Regulation 1525.4 to further implement, interpret, and make specific the partial exemption from sales and use tax provided by RTC section 6377.1. The partial exemption became effective on July 1, 2014, and is not being utilized as anticipated and intended by the Legislature, which may be due to the ambiguity in RTC section 6377.1 that the amendments are intended to clarify. Also, once the proposed amendments are effective, the clarification 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 the proposed clarifying amendments to Regulation 1525.4 in order to help ensure that the partial exemption begins to be utilized as originally anticipated and intended by the Legislature, as soon as possible, and the Board may request an early effective date for the proposed amendments to Regulation 1525.4, pursuant to Government Code section 11343.4, subdivision (b)(3).

AVAILABILITY OF FINAL STATEMENT OF REASONS

If the Board adopts the proposed amendments to 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 November 17, 2015 Board Meeting

Joann Richmond

Joann Richmond, Chief
Board Proceedings Division

Initial Statement of Reasons for
Proposed Amendments to California Code of Regulations, Title 18, Section 1525.4, *Manufacturing and Research & Development Equipment*

SPECIFIC PURPOSE, PROBLEM 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), § 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, § (Regulation or Reg. 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, § 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; Regs. 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 exemption provided by RTC section 6377.1, subdivision (a), is referred to as a partial exemption because RTC section 6377.1, subdivision (d), specifies that the 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; and 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.

RTC section 6377.1, subdivision (a), provides that the partial exemption provided by RTC section 6377.1 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.

As relevant here, RTC section 6377.1, subdivision (b)(7), defines the term "qualified tangible personal property," as follows for purposes of the partial exemption:

> (7)(A) "Qualified tangible personal property" includes, but is not limited to, all of the following:

(i) Machinery and equipment, including component parts and contrivances such as belts, shafts, moving parts, and operating structures.
(ii) 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.
(iii) Tangible personal property used in pollution control that meets standards established by this state or any local or regional governmental agency within this state.
(iv) 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.
(B) "Qualified tangible personal property" shall not include any of the following:
(i) Consumables with a useful life of less than one year.
(ii) 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.
(iii) Tangible personal property used primarily in administration, general management, or marketing.

As relevant here, RTC section 6377.1, subdivision (b)(10), defines the term "useful life," which is used in the definition of "qualified tangible personal property." Subdivision (b)(10) provides that "'Useful life' for tangible personal property that is treated 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 section. '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 purposes of this section" (hereafter also referred to as the "deemed" provisions of RTC section 6377.1).

Also, as relevant here, the Legislature intended for the partial exemption provided by RTC section 6377.1 to be fully utilized and, to ensure such utilization, RTC section 6377.1, subdivision (g), provides that:

(g)(1) Upon the effective date of this section, the Department of Finance shall estimate the total dollar amount of exemptions that will be taken for each calendar year, or any portion thereof, for which this section provides an exemption.
(2) No later than each March 1 next following a calendar year for which this section provides an exemption, the board shall provide to the Joint

> Legislative Budget Committee a report of the total dollar amount of exemptions taken under this section for the immediately preceding calendar year. The report shall compare the total dollar amount of exemptions taken under this section for that calendar year with the department's estimate for that same calendar year. If that total dollar amount taken is less than the estimate for that calendar year, the report shall identify options for increasing exemptions taken so as to meet estimated amounts.

In addition, the Board adopted Regulation 1525.4, *Manufacturing and Research & Development Equipment*, for the specific purpose of fully implementing, interpreting, and making specific the provisions of RTC section 6377.1 on April 22, 2014, and the regulation became effective on September 25, 2014. As relevant here, Regulation 1525.4, subdivision (b)(9), incorporates the definition of "qualified tangible personal property" from RTC section 6377.1, subdivision (b)(7) (with some minor clarifications that are not relevant here). And, Regulation 1525.4, subdivision (b)(13), incorporates the definition of "useful life" from the "deemed" provisions of RTC section 6377.1, and provides as follows:

> (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.

Furthermore, as relevant here, for federal income tax purposes:

- A taxpayer is generally allowed a current deduction, under Internal Revenue Code (IRC) section 162, for the entire cost of tangible personal property used in a trade or business that has a useful life of 12-months or less;
- A taxpayer is allowed to capitalize the cost of tangible personal property that is used in a trade or business and has a useful life of more than 12 months, and a taxpayer is only generally allowed to annually claim a depreciation deduction for part of the cost of the property (or capital asset) as it is exhausted over its useful life, under IRC section 167; and
- A taxpayer also is generally permitted to "elect" to treat the entire cost of tangible personal property used in a trade or business with a useful life of more than 12 months as a current deduction, under IRC section 179, subject to certain limitations that are not relevant here.

Both California's Personal Income Tax Law (RTC, § 17001 et seq.) and Corporation Tax Law (RTC, § 23001 et seq.) either generally incorporate or contain similar provisions to IRC sections 162, 167, and 179. (See, RTC, §§ 17201, 24343, 24349, 24356, subd. (b)(1)). Therefore, for state franchise and income tax purposes, a qualified person (as

defined in RTC, § 6377.1) may treat the entire cost of otherwise qualified tangible personal property with a useful life of exactly one year (or 12 months) as a current deduction, under the provisions of IRC section 162 incorporated into or contained in California law, and may either treat all or a part of the cost of otherwise qualified tangible personal property with a useful life of more than one year (or 12 months) as a current deduction, under the provisions of IRC sections 167 and 179 incorporated into or contained in California law.

Proposed Amendments

Rulemaking Petition

On Tuesday, July 21, 2015, the Board's Legal Department received a petition dated July 21, 2015, from Ms. Teresa Casazza on behalf of the California Taxpayers Association (CalTax), pursuant to Government Code section 11340.6, requesting that the Board amend Regulation 1525.4 to add clarifying language so that taxpayers may substantiate that tangible personal property satisfies the useful life qualification in RTC section 6377.1 by reference to either warranties, maintenance agreements, or industry replacement standards. The petition explained that:

> 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.

The attachment to the petition also specifically recommended that the Board amend Regulation 1525.4, subdivision (b)(13), to read as follows:

(13)(A)[1] "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 personal[2] 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.

[1] The attachment illustrated the requested amendments in italics, and they are shown here in underline.
[2] The attachment inadvertently omitted the word "personal" from the text of proposed subdivision (b)(13)(B)1.

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.

Chief Counsel Memorandum

The Board's Legal Department prepared a Chief Counsel Memorandum dated August 3, 2015, which set forth relevant background information pertaining to the adoption of Regulation 1525.4, provided a discussion of CalTax's petition, and provided Board staff's response. CalTax's petition and Formal Issue Paper 14-001 regarding the Board's adoption of Regulation 1525.4 were also included as attachments to the Chief Counsel Memorandum.

The Chief Counsel Memorandum explained that staff "recognizes that [RTC] 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 [the] '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 [with a useful life of more than one year] 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."

The Chief Counsel Memorandum explained that "CalTax asserts that the explicit language in subdivision (b)(7)(A)(i) makes it clear that the Legislature intended [for the partial exemption to apply to] the component parts and contrivances of machinery and equipment. CalTax further asserts that limiting the [partial] exemption [by narrowly applying] subdivision (b)(10) of that section would needlessly thwart the purpose and intent of RTC section 6377.1."

The Chief Counsel Memorandum also advised the Board, that "[i]f 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, [then,] subject to approval by the Office of Administrative Law [(OAL)], CalTax's requested amendments will address the issues raised by CalTax and effectuate such legislative intent."

August 25, 2015, Board Meeting

The Chief Counsel Memorandum dated August 3, 2015, and CalTax's petition were submitted to the Board Members for consideration during the Board's August 25, 2015, meeting. During the meeting, Board staff introduced the agenda item. Board staff said that, "[a]lthough staff has concerns about the 'deemed' provisions of [RTC] section 6377.1, [staff understands] the perceived ambiguities in the [entire] section's wording and [staff realizes] that reasonable minds may differ on its interpretation." Board staff said that "[i]f the Board agrees, in light of the entire statutory scheme, [that] 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 the approval by [OAL], [Caltax's] proposed amendment[s] will address the issues raised by CalTax and effectuate such legislative intent." Staff also said that staff did not "regard [CalTax's] proposal as having a revenue impact since, subject to the approval by [OAL], [the requested amendments] would be regarded as consistent with the implementing statute." Furthermore, staff said that "for the first year, the [partial] exemption usage was anticipated to be [based on] approximately $15 billion [of expenditures]. However, based upon returns to date, we have [only] seen approximately $3 billion of usage," which may be due to the perceived ambiguities in the statute.

During the discussion of the item, Ms. Therese Twomey, Fiscal Policy Director for CalTax, asked the Board to grant the petition to add the clarifying language to Regulation 1525.4. Ms. Twomey said that "there is ambiguity in the statute," the "ambiguity has prohibited some taxpayers [from qualifying] for the exemption" and, therefore, prevented the partial exemption from generating "the economic activity that was intended by the Legislature" to help increase manufacturing and manufacturing jobs in California. Ms. Twomey also said that CalTax's requested amendments will "allow California taxpayers to better verify and to have the Board substantiate that the 'useful life' language can be substantiated through either a warranty that lasts more than one year, a maintenance contract that lasts more than one year, or industry replacement standards that last for more than one year."

In addition, Ms. Twomey pointed out that RTC section 6377.1, subdivision (g), "itself asks the [Board] to take a look at utilization as well as to compare the utilization to the amount that was estimated, and in the event that that utilization is lower than what is estimated, that the Board make recommendations and pursue changes in order to garner the amount that was initially intended and the economic activity that was intended." She also said that CalTax has "discussed [utilization] with the Department of Finance. And as a matter of fact, they have been asking [CalTax] why utilization is so low" and they are relying on CalTax "to provide the industry's perspective as to why. . . ."

Furthermore, during the discussion of the item, Deputy State Controller Yvette Stowers said that she and State Controller Betty Yee "support having businesses benefit from this exemption and we acknowledge that it is underutilized." However, she also expressed the concern that the useful life requirement "needs to be fixed in the statute first, as opposed to the regulation" and she said "[f]or that fact" she would "not be voting yes to accept the petition."

In response, Board Chairman Jerome Horton agreed with Ms. Stowers that it would be good to have a statutory fix, but he also expressed serious concerns about the underutilization of the partial exemption and the delays associated with solely pursuing a statutory fix. So, Chairman Horton urged the Board to try to fix the situation by amending the regulation as requested by CalTax.

Also, Board Members George Runner, Diane Harkey and Fiona Ma agreed with Chairman Horton that the Board should try to fix the situation by amending the regulation as requested by CalTax. Both Chairman Horton and Board Member Runner expressed their understanding that OAL would serve as a "backstop" if a statutory fix is legally required before the Board can amend the regulation. And, Board Member Ma explained that, based upon her experience in the Legislature, the Legislature does not have the time to specifically address every regulatory issue in proposed legislation, and the Legislature often enacts legislation with the expectation that the implementing agencies will adopt regulations to address specific regulatory issues when necessary.

At the conclusion of the Board discussion of the item, Chairman Horton and Board Members Harkey, Runner, and Ma voted to grant CalTax's petition and propose the

requested amendments to Regulation 1525.4. The Board determined that there is an issue (or problem within the meaning of Gov. Code, 11346.2, subd. (b)) because RTC section 6377.1 does not specify whether a qualified person who currently deducts the entire cost of otherwise qualified tangible personal property that actually has a useful life of one or more years is "treating" such property as having a useful life of less than one year or a useful life of one or more years for state franchise and income tax purposes. RTC section 6377.1 does not expressly state that its "deemed" provisions are the exclusive means by which a qualified person may substantiate that otherwise qualified tangible personal property has a useful life of one or more years for purposes of the partial exemption. RTC section 6377.1 does not provide other reasonable means to establish that otherwise qualified tangible personal property has a useful life of one or more years. And, the lack of specificity creates an ambiguity as to whether it is permissible to use other reasonable methods to substantiate the useful life of otherwise qualified tangible personal property under the statute. The Board also determined that the amendments requested in CalTax's petition are reasonably necessary for the specific purpose of addressing the issue (or problem) created by the ambiguity in the statute by adding clarifying provisions to the regulation expressly permitting taxpayers to substantiate the useful life of otherwise qualified tangible personal property using other reasonable means, including a warranty, service contract, or industry practice.

The Board anticipates that the proposed amendments will benefit qualified persons who deduct, rather than capitalize, the cost of otherwise qualified tangible personal property on their state franchise and income tax returns by clarifying that they may substantiate that such property satisfies the "useful life" requirements for the partial exemption provided by RTC section 6377.1 using a warranty, service contract, or industry practice. The Board anticipates that the proposed amendments will benefit all taxpayers by promoting fairness and helping ensure that similarly situated taxpayers, such as Taxpayer A and Taxpayer B referred to in CalTax's petition, do not receive disparate treatment. The Board also anticipates that the proposed amendments will generally benefit the people of the State of California by helping ensure that the partial exemption provided by RTC section 6377.1 is utilized as originally anticipated by the Legislature and that the statute increases manufacturing and manufacturing jobs in California as the Legislature intended.

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

DOCUMENTS RELIED UPON

The Board relied upon the Chief Counsel Memorandum dated August 3, 2015, the attachments to the memorandum, including CalTax's petition, and the comments made during the Board's discussion of CalTax's petition during its August 25, 2015, Board meeting in deciding to propose the amendments to Regulation 1525.4, described above.

ALTERNATIVES CONSIDERED

The Board considered whether to deny CalTax's petition, propose to adopt CalTax's requested amendments to Regulation 1525.4 in whole or in part, or take other appropriate action during its meeting on August 25, 2015. During the meeting, the Board decided to propose to adopt all of the amendments to Regulation 1525.4 requested by CalTax because the Board determined that the adoption of the proposed amendments is reasonably necessary for the reasons provided above.

The Board did not reject any reasonable alternative to the proposed amendments to 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)

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. Also, as explained above, the Legislature intended for the partial exemption provided by RTC section 6377.1 to be fully utilized and, to ensure such utilization, RTC section 6377.1, subdivision (g), required the Department of Finance to estimate the total dollar amount of exemptions that will be taken for each calendar year the partial exemption will be in effect and requires the Board to annually report the total dollar amount of exemptions taken for the immediately preceding calendar year, compare the total dollar amount of those exemptions to the Department of Finance's estimate for that same year, and identify options for increasing exemptions taken so as to meet the Department of Finance's estimates when necessary. And, the Board anticipates that RTC section 6377.1 will continue to have an economic impact on business and state revenue as intended the Legislature intended.

As explained in more detail above, RTC section 6377.1, subdivision (b)(7), requires that tangible personal property have a useful life of one or more years in order for that property to be "qualified tangible personal property" for purposes of the partial exemption, and RTC section 6377.1, subdivision (b)(10), provides that: "'Useful life' for tangible personal property that is treated 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 section. '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 purposes of this section."

The Board has determined that there is an issue because RTC section 6377.1 does not specify whether a qualified person who currently deducts the entire cost of otherwise qualified tangible personal property that actually has a useful life of one or more years is "treating" such property as having a useful life of less than one year or a useful life of one or more years for state franchise and income tax purposes. RTC section 6377.1 does not expressly state that its "deemed" provisions are the exclusive means by which a qualified person may substantiate that otherwise qualified tangible personal property has a useful life of one or more years for purposes of the partial exemption. RTC section 6377.1 does not provide other reasonable means to establish that otherwise qualified tangible personal property has a useful life of one or more years. And, the lack of specificity creates an ambiguity as to whether it is permissible to use other reasonable methods to substantiate the useful life of otherwise qualified tangible personal property under the statute. The Board also determined that the amendments to Regulation 1525.4 requested in CalTax's petition (discussed above) are reasonably necessary for the specific purpose of addressing the issue created by the ambiguity in the statute by adding clarifying provisions to the regulation expressly permitting taxpayers to substantiate the useful life of otherwise qualified tangible personal property using other reasonable means, including a warranty, service contract, or industry practice.

The Board anticipates that the proposed amendments will benefit qualified persons who deduct, rather than capitalize, the cost of otherwise qualified tangible personal property on their state franchise and income tax returns by clarifying that they may substantiate that such property satisfies the "useful life" requirements for the partial exemption provided by RTC section 6377.1 using a warranty, service contract, or industry practice. The Board anticipates that the proposed amendments will benefit all taxpayers by promoting fairness and helping ensure that similarly situated taxpayers, such as Taxpayer A and Taxpayer B referred to in CalTax's petition, do not receive disparate treatment. The Board also anticipates that the proposed amendments will generally benefit the people of the State of California by helping ensure that the partial exemption provided by RTC section 6377.1 is utilized as originally anticipated by the Legislature and that the statute increases manufacturing and manufacturing jobs in California as the Legislature intended.

The Board has also determined that the proposed amendments to Regulation 1525.4 are fully consistent with current law, including RTC section 6377.1, subject to OAL approval, and there is nothing in the proposed amendments that would significantly change how the Legislature intended for individuals and businesses to behave in response to RTC section 6377.1. Therefore, the Board estimates that the proposed amendments, themselves, 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 amendments to Regulation 1525.4 are 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 amendments 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 the proposed amendments to Regulation 1525.4 do 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 the proposed amendments to 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 the proposed amendments to 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, Regulation 1525.4 does 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 the proposed amendments to 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 the proposed amendments to Regulation 1525.4 will not have a significant adverse economic impact on business.

The adoption of the proposed amendments to Regulation 1525.4 may affect small businesses.

Text of Proposed Amendments to

California Code of Regulations, Title 18, Section 1525.4,

Manufacturing and Research & Development Equipment

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)(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 personal 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.

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: Bradley Heller
Legal Contact: Bradley Heller

The State Board of Equalization proposes to adopt amendments to Sales and Use Tax Regulation 1525.4, *Manufacturing and Research & Development Equipment*, to clarifying that taxpayers may substantiate the useful life of otherwise qualified tangible personal property using a warranty, service contract, or industry practice

History of Proposed Regulation:

November 17-19, 2015	Public Hearing
September 25, 2015	OAL publication date; 45-day public comment period begins; Interested Parties mailing
September 15, 2015	Notice to OAL
August 25, 2015	Chief Counsel Matters, Board Authorized Publication (Vote 4-1)

Sponsor:	NA
Support:	NA
Oppose:	NA

Statement of Compliance

The State Board of Equalization, in process of adopting Sales and Use Tax Regulation 1525.4, *Manufacturing and Research & Development Equipment*, did comply with the provision of Government Code section 11346.4(a)(1) through (4). A notice to interested parties was mailed on September 25, 2015, 53 days prior to the public hearing.

November 20, 2015

Richard Bennion
Regulations Coordinator
State Board of Equalization

DEPARTMENT OF FINANCE

EDMUND G. BROWN JR. • GOVERNOR
915 L STREET ■ SACRAMENTO CA ■ 95814-3706 ■ WWW.DOF.CA.GOV

November 10, 2015

Rick Bennion, Regulations Coordinator
State Board of Equalization
450 N Street
Sacramento, CA 94279-0080

Dear Mr. Bennion:

As Finance has noted previously, the Board of Equalization lacks the statutory authority to enact the proposed amendments to the sales tax exemption regulations. The statute is very clear in outlining the requirements for manufacturers to qualify for the exemption, and as the board acknowledged in the August meeting, these amendments would overstep the delegated authority. As the Office of Administrative Law (OAL) may not have been aware of the statutory constraints, we encourage you to check with them now so that the regulations may be withdrawn.

If the board continues the regulatory process rather than withdrawing the regulations, the package submitted does not comply with existing requirements. Specifically, the STD. 399 must be revised to include the fiscal impact, and the board would need to complete a Standardized Regulatory Impact Assessment (SRIA) to meet the major regulations requirements.

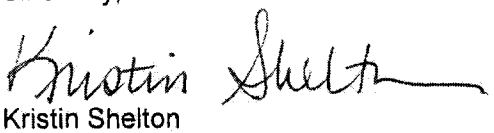
The argument that these amendments would have no revenue impact because they "would be consistent with the implementing statute" is insufficient. Even when legislation contemplates increased expenditures or revenue losses (tax expenditures), they must be reflected in the STD. 399. In addition, to the extent these regulations are further revised to resolve a statutory ambiguity to increase utilization of the exemption, the increase in the exemption over what would be expected under the current regulations would result in a revenue loss. Therefore, this revenue loss results in a fiscal impact. As the amendments would trigger a fiscal impact from the additional exemptions, a signature is also required from Finance on a STD. 399 before these regulations can be adopted. If OAL chooses to allow the board to proceed with these regulations, that STD. 399 must be forwarded to Finance for approval.

In addition, the proposed regulations meet the $50 million economic impact threshold for major regulations. As a result, a SRIA is required before the regulations can be adopted or the rulemaking process finalized pursuant to the California Code of Regulations. The sales tax exemption amendments have the stated purpose of encouraging manufacturers to purchase additional equipment without paying sales tax. While the level of additional exemptions claimed under the proposed amendments is not clear, the board notes that in the current year the amount of qualified expenditures claimed was $12 billion less than was anticipated when the legislation was adopted. If even a small fraction of this $12 billion gap is closed by these amendments, the threshold of $50 million of economic activity in one twelve-month period would be exceeded.

As we have discussed, Government Code section 11346.3 and California Code of Regulations, title 1, sections 2002 and 2003 require an agency promulgating major regulations to prepare and submit a SRIA to the Department of Finance. The agency must summarize and respond to Finance's comments, and include them with the notice of proposed action filed with OAL. California Code of Regulations, title 1, section 2002(a)(1) requires that a SRIA be submitted to Finance not less than 60 days prior to the filing of a notice of proposed action with the OAL. Because this deadline has already passed, we will work to provide formal comments as soon as possible following receipt of a SRIA. The SRIA, a summary of Finance's comments, and the board response would then need to be circulated for public comment.

If these regulations are not withdrawn, we look forward to your prompt submittal of the required fiscal and economic impact documents.

Sincerely,



Kristin Shelton
Program Budget Manager

cc: Ms. Panorea Avdis, Executive Director, Governor's Office on Business and Economic Development
Ms. Debra Cornez, Director, Office of Administrative Law
Ms. Cynthia Bridges, Executive Director, Board of Equalization
Mr. Bradley Heller, Board of Equalization

BEFORE THE CALIFORNIA STATE BOARD OF EQUALIZATION

5901 GREEN VALLEY CIRCLE

CULVER CITY, CALIFORNIA

REPORTER'S TRANSCRIPT

NOVEMBER 17, 2015

F PUBLIC HEARING

F1 PROPOSED AMENDMENTS TO

SALES AND USE TAX REGULATION 1525.4

MANUFACTURING AND RESEARCH AND

DEVELOPMENT EQUIPMENT

Reported by: Juli Price Jackson

No. CSR 5214

Electronically signed by Juli Jackson (001-065-206-4972) bee1c38a-f634-4935-a23c-aa147f68b1de

1 P R E S E N T

2 For the Board of Equalization: Jerome E. Horton
Chairman

3

4 Sen. George Runner (Ret.)
Vice-Chairman

5

6 Fiona Ma, CPA
Member

7

8 Diane L. Harkey
Member

9

10 Yvette Stowers
Appearing for Betty T.
11 Yee, State Controller
(per Government Code
12 Section 7.9)

13

Joann Richmond
14 Chief, Board
Proceedings Division

15

16 For Staff: Robert Tucker
Tax Counsel IV
17 Legal Department

18

19 ---oOo---

20 Speaker: Therese Twomey
Fiscal Policy Director
21 California Taxpayers
Association

22

23 ---oOo---

24

25

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27

28

1 5901 GREEN VALLEY CIRCLE
2 CULVER CITY, CALIFORNIA
3 NOVEMBER 17, 2015
4 ---oOo---
5 MR. HORTON: Welcome back, Members.
6 MR. RUNNER: This is like your house, isn't
7 it?
8 MR. HORTON: No -- maybe the guest house.
9 Members, let us reconvene the meeting of
10 the Board of Equalization.
11 Ms. Richmond, what is our next matter?
12 MS. RICHMOND: Our next matter on today's
13 agenda is item F, Public Hearing, F1, Proposed
14 Amendments to Sales and Use Tax Regulation 1525.4,
15 Manufacturing and Research and Development
16 Equipment.
17 And we do have someone who wishes to make a
18 public comment.
19 MR. HORTON: Thank you.
20 Members, we have Ms. Therese Twomey with --
21 the Fiscal Policy Director for the California
22 Taxpayers Association.
23 We'd ask that she come forward after
24 Mr. Tucker makes his opening remarks.
25 MR. TUCKER: Yes, I'm Bob Tucker with the
26 Board's Legal Department. Here -- we're here for
27 the public hearing for proposed amendments to Sales
28 and Use Tax Regulation 1525.4, Manufacturing and

Electronically signed by Juli Jackson (001-065-206-4972) bee1c38a-f634-4935-a23c-aa147f68b1de

1 Research and Development Equipment.
2 This is the public hearing regarding the
3 proposed amendments clarifying that taxpayers may
4 substantiate the useful life of property using a
5 warranty, service contract or industry practice.
6 This is the opportunity for the Board to
7 adopt these amendments. However, there's been a
8 recent development.
9 A letter was received from Department of
10 Finance and Finance -- Department of Finance has
11 some objections to these amendments.
12 Ms. Kirsten Shelton, the program budget
13 manager for Department of Finance, issued in her
14 letter -- expressed some concern over these
15 amendments.
16 One, objecting to -- her statement -- that
17 she believes the Board has overstepped its delegated
18 authority, and the second objection relates to the
19 economic impact statements that were provided for
20 these amendments.
21 As in regards to the first statement about
22 overstepping authority, the staff recognized that
23 Revenue and Taxation Code Section 6377.1 may be
24 interpreted by some as ambiguous and potentially
25 inconsistent with its drafting.
26 It was understood that the perceived
27 ambiguities -- that with these ambiguities
28 reasonable minds could differ. Staff indicated that

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1 if the Board agreed, in the light of the entire
2 statutory scheme, that the legislature intended to
3 make the partial exemption available for these items
4 with a useful life of one year or more, subject to
5 approvable -- approval by the Office of
6 Administrative Law, the proposed amendments would
7 address the issues raised by Cal-Tax, and effectuate
8 such legislative intent.
9 However, DOF believes that -- DOF meaning
10 Department of Finance -- means that the -- has said
11 that the Board is required to prepare a standard
12 form 399, which the Board did prepare. However, we
13 prepared it as having no fiscal impact because we
14 believe that the fiscal impact is covered by the
15 enacting statute.
16 They have stated that they think that -- in
17 their opinion, that there is a significant fiscal
18 impact. And we would be required to amend such
19 standard 399 and required to obtain their
20 concurrence in the assessment of some impact -- or
21 the impact before the publishing of the notice.
22 They have also said that based on their
23 interpretation, they believe there is a -- this
24 would result in a major regulation, which means it
25 would have an impact exceeding $50 million in a
26 12-month period.
27 We did not -- we did not believe it was a
28 major regulation and, accordingly, we submitted the

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1 standard 399.

2 As a result, OAL may not approve -- and

3 this is the possible consequence -- OAL may not

4 approve the agency's proposed regulatory action if

5 it determines that the agency failed to

6 substantially comply with the requirement to

7 determine the fiscal impact of the proposed

8 regulatory action or prepare an economic impact

9 statement for the proposed non major regulation or

10 the SRIA, which is the major regulation.

11 In general -- and I don't mean anything to

12 demean OAL -- but OAL doesn't have the experience

13 that Department of Finance has, so, we would expect

14 that OAL would, in all likelihood, take and look at

15 DOF's expertise in assessing the economic and fiscal

16 impact, and weigh that heavily when they make their

17 decision.

18 If the Board chooses to adopt the proposed

19 amendments during this hearing, then it is -- it

20 appears that OAL may not approve such amendments.

21 And, as a result -- this is based on their reliance

22 on the Department of Finance.

23 At this stage in the rulemaking process, if

24 the Board has concerns about the Department of

25 Finance letter, the Board can decide not to proceed

26 with the proposed amendments and publish a notice to

27 that effect in the California Notice Register. And

28 that would end the current proposal to amend

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1 Regulation 1525.4, but without affecting the Board's
2 authority to amend the regulation in the future.
3 The Board cannot withdraw the regulation at
4 this time from OAL's consideration, which was
5 discussed in the Department of Finance letter,
6 simply because it hasn't been submitted to OAL yet.
7 Unless the Board actually adopts the
8 proposed amendments and submits the completed
9 package to OAL, at that time if they were to change
10 their mind, then they could withdraw. But it's
11 simply not feasible to withdraw at this time.
12 Accordingly, if the Board chooses to adopt
13 the proposed amendments and submit the rulemaking
14 file to OAL, there are a couple options that would
15 exist.
16 If it's submitted to OAL and OAL disproves
17 the proposed amendments based on any grounds,
18 then -- and most likely we would anticipate it would
19 be based on the DOF letter -- OAL must provide the
20 Board a written opinion regarding the disproval.
21 The Board would have ten days to file a
22 written request for review of OAL's opinion with the
23 Governor's Legal Affairs Secretary, and have OAL's
24 opinion reviewed by the Governor. And OAL's
25 decision would be become final if not appealed
26 within that ten-day period.
27 However, in this case, if they do actually
28 disprove the proposed amendments, it's our opinion

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1 that, in all likelihood, we do not think that an
2 appeal would be fruitful or that it would result in
3 the Governor's office overturning OAL at this point.
4 That's simply our interpretation.
5 However, ultimately, it's for the Board to
6 decide how they want to proceed at this point.
7 And at this point I will hand off to
8 Ms. Twomey.
9 MR. HORTON: Thank you very much.
10 THERESE TWOMEY
11 MS. TWOMEY: Good afternoon, Members.
12 Good afternoon, Members. Thank you for the
13 privilege to provide testimony on this issue.
14 And thank you again for your ongoing,
15 continued leadership on this issue, as well as the
16 dedication and hard work on your staff since the
17 legislation was passed in 2013.
18 There are a couple of important points I'd
19 like to address. The first has to do with the
20 Board's authority. The Board is fully within its
21 vested authority to make regulatory changes to
22 provide taxpayer guidance on this issue. And that's
23 simply what the proposed amendments that your Board
24 has looked at, has drafted with our cooperation.
25 This is a matter in which taxpayers are
26 asking for an interpretation on an ambiguity that is
27 apparent in the statute itself.
28 If you interpret the statute the way that

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1 it's currently being interpreted, then it provides
2 an inherent conflict of two provisions in the
3 statute itself. The way that the amendments specify
4 the interpretation would be to allow taxpayers and
5 the Board of Equalization to administer the statute
6 the way it was intended by the legislature.
7 So, within those parameters -- to provide
8 guidance to taxpayers, to provide guidance in the
9 administration both to the Board of Equalization
10 staff and to taxpayers -- that is fully within the
11 power and the authority and the responsibility of
12 the Board of Equalization.
13 The second point that I'd like to address
14 is the economic impact. When this legislation was
15 moving forward in the legislature, this was part of
16 a three-part plan. The Governor's plan was to
17 eliminate the enterprise zones. And with
18 elimination of the enterprise zones, to replace it
19 with three incentives.
20 The biggest incentive is this
21 manufacturer's exemption -- excuse me. The other
22 two incentives have to do with hiring credit, as
23 well as the California GO-Biz Competes.
24 The intent was to have these three new
25 incentives be revenue neutral to the elimination of
26 the enterprise zones.
27 Finance's own estimate of all three to
28 become revenue neutral was a minus of $750 million

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1 for the enterprise zones and a plus of $750 million
2 for all three components.
3 By Finance's own estimate, as indicated in
4 the floor analysis when this bill went through the
5 legislature for final vote, Finance's estimate was
6 that taxpayers would be allowed to use $486 million
7 of this exemption. To date, the utilization based
8 on the interpretation of that statute, is 25
9 percent.
10 Our petition is to ask for simple,
11 clarifying, interpretative language to provide
12 taxpayers with the guidance necessary in order to
13 give them comfort to use this exemption.
14 That is what the Board did in August when
15 we heard this issue. We ask currently, now, that
16 the Board transmit the regulations to the Office of
17 Administrative Law. That is because we disagree
18 with the Department of Finance's assessment that the
19 economic impact is a cost increase, when Finance's
20 own numbers were $486 million, we're now using --
21 taxpayers are being able to utilize a little bit
22 over 25 percent of that. It's unclear how that can
23 be, quote, unquote, "a cost increase."
24 Therefore, we're asking for additional time
25 to work with the administration towards resolution.
26 And by doing so, we request respectfully that the
27 Board transmit the regulations and the proposed
28 amendments to the Office of Administrative Law to

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1 allow us that time.
2 We've also requested a meeting with the
3 Governor's office to work with him on how to ensure
4 that this revenue -- this proposal is revenue
5 neutral, consistent with his economic plan for
6 trying to improve the manufacturer's exemption in
7 California and make California more competitive.
8 With that, I thank you for your
9 consideration and for your time.
10 MR. HORTON: Thank you very much.
11 Discussion, Members? Member Runner.
12 MR. RUNNER: Yeah, just a quick question
13 on -- when do we -- how -- what would be the
14 timetable that we'd assume -- I'm -- it's probably
15 in statute -- that OAL has to review this?
16 MR. TUCKER: Off the top of my head -- I
17 have to check back.
18 MR. RUNNER: Okay.
19 MR. TUCKER: I apologize.
20 MR. RUNNER: Okay. I'm just -- I mean, I
21 just wondered again --
22 MR. TUCKER: Perhaps thirty days.
23 MR. RUNNER: Okay. Okay, I mean, I guess
24 my view here is that, you know, I think we clearly
25 have some interesting discussions going on in
26 regards to our authority, in regards to definition
27 of economic impact.
28 You know, I do believe -- and again if

1 people recall back when this was a debated issue in
2 the legislature, this whole idea, that number was a
3 very hotly contested issue because they were trading
4 one -- one economic stimulus for another one. And
5 it needed to be -- and the num -- and the total
6 dollars were a part of that package.
7 And, so, it seems to me that I don't think
8 there is anything wrong with us looking at that as
9 the number in regards to the economic impact in
10 regards to the fact that this is below that and this
11 is not a new, additional $50 million and all of a
12 sudden we're having an impact.
13 The other side is as I -- again I -- I
14 would be concerned that we fully -- and unless the
15 Board would decide that we are actually not moving
16 in our authority, I would assume that it would best
17 for us to truly move out and continue in this
18 direction and let OAL and Finance make their
19 statements.
20 And at the end of the day we do our due
21 diligence and we thought we were okay. And they
22 choose to somehow, you know, determine that we
23 were -- that these are needed, well, then, that's
24 fine.
25 But I -- I'm concerned about us kind of
26 stopping our process when it is that we have an
27 opinion letter that's been kind of -- not an
28 official opinion letter, but a letter with an

1 opinion in it -- from Finance telling us to go ahead
2 and withdraw our hold on that issue.
3 I also think it's important, it seems to
4 me, that as this is a debated issue that by moving
5 forward with it we do give Cal-Tax a chance to go
6 ahead and have conversations with the Governor's
7 office, which is not necessarily equivalent to
8 Finance, and help them go ahead and determine if
9 there's a path that they can then find as this
10 regulation moves forward.
11 So, I'm supportive of us moving forward
12 with it. And I think it's within our authority.
13 And then let's just see what the next part of the
14 process holds.
15 MR. HORTON: Ms. Stowers.
16 MS. STOWERS: No, sir -- well, I do have a
17 comment.
18 Just for the record, I still object as
19 moving forward.
20 MR. HORTON: Member Harkey.
21 MS. HARKEY: I just -- this is a question
22 for Therese, if we get the same response back and
23 you need to run this statutorily, are you going to
24 be finding a steeper uphill battle by carrying this
25 forward now?
26 MS. TWOMEY: I don't believe so. I think
27 that having the proposal move forward signals from
28 the BOE that on a policy basis, not on procedural

1 or, you know, what Finance thinks, that on a policy
2 basis the Board of Equalization supports being able
3 to implement this piece of law the way the
4 legislature intended it to.
5 And I think that would add to and help our
6 legislative process as opposed to being a
7 detriment.
8 MS. HARKEY: Okay. So, you feel it's
9 additive and that -- you know, we thought it was
10 within our purview, so --
11 MS. TWOMEY: And we agreed.
12 MS. HARKEY: -- thank you.
13 MR. HORTON: Members, at no point do we
14 want to minimize our authority, which would -- is
15 pretty much what the Department of Finance would be
16 asking relative to their inquiry about our
17 authority, from my perspective.
18 The Board of Equalization has the authority
19 to make a recommendation. We don't -- we recommend
20 legislation. And the legislation goes to the Office
21 of Administrative Law. And if they sign off on it
22 or say we're not doing anything we shouldn't be
23 doing, then it goes into -- into play.
24 The -- the challenge that I have here is
25 that the -- the Department of Finance has raised a
26 technicality. And I'm just interested -- interested
27 in either one of you responding to that technicality
28 that this may be a major regulation, that there may

1 be -- Ms. Twomey has already shared her thoughts
2 with the Department -- there may be a cost factor,
3 economic cost factor.
4 Were you able to at least inquire of our
5 economists to see -- I think the concern, if I just
6 may sort of put my two cents in, is not that it
7 increases the projected costs relative -- because
8 only 25 percent has been consumed, we are, to some
9 degree, expanding the -- those -- expanding the
10 definition to some degree do allow more people to
11 actually utilize this, which is a wise thing, I
12 think, on our part. But in doing so, it may -- it
13 may actually increase the usage, hopefully. And
14 increasing the usage may result in this additional
15 cost factor that Department of Finance has put
16 forth.
17 So, there's a question there and a
18 statement.
19 MR. TUCKER: I'll --
20 MR. HORTON: Mr. Tucker.
21 MR. TUCKER: -- I'll do the best I can to
22 answer.
23 Initially we determined that this was not a
24 major regulation, simply because we looked to the
25 enabling and enacting -- pardon me -- statute. And,
26 so, we looked at the cost being associated with the
27 statute, not with the regulation. So, that's why we
28 determined that there was, at the point, zero

1 impact.

2 We did not look at it from the perspective,

3 as the DOF letter points out, that it would be a

4 major regulation because we didn't attribute any

5 cost to anything other than the underlying statute.

6 However, it -- if we were to do such a

7 review, it would -- it's something -- it would be

8 new for us. We have not done so historically. We

9 have simply looked to whatever the enacting statute

10 was and attributed the costs there.

11 MR. HORTON: Yeah, the -- Members, it sort

12 of seems to me that the Department of Finance has

13 put a poison pill in there with that major

14 regulation language.

15 And, so, the Department -- the Office of

16 Administrative Law, relying on the Department of

17 Finance, believing that it is there, with that

18 poison pill in there, is just going to deny it.

19 And, so, even if we go forward, we're going

20 forth knowing that the odds are pretty good that

21 Office of Administrative Law is going to follow

22 Department of Finance and not assess whether or not

23 we are right that this is not a major regulation

24 because we have not put forth any economic numbers

25 saying that we believe it is not.

26 So, at a minimum, we ought to say

27 that based on something that we believe, that this

28 is not a major -- that the cost estimate by the

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1 Department of Finance is high or doesn't exist or is
2 not existing or something do that effect, so that --
3 and that, I think, positions us to at least call
4 into question this technicality.
5 We don't call it into question, it stands
6 as the Office of Administrative Law's reality, and
7 it gets denied. And basically we're poking the bear
8 in the face for -- and I don't -- I can't find a
9 reason to do that at this point.
10 MS. TWOMEY: We would also be working with
11 the Department of Finance and the Governor's office
12 primarily to address that issue as well.
13 MR. HORTON: Is -- from the timelines, is
14 there a way that we could put this over to give them
15 time to talk to the Governor's office or --
16 MS. TWOMEY: We put in a request as soon as
17 we -- the issue has been that we were not informed
18 of Finance's objection until very late last week.
19 So, as soon as we found out, we put in a
20 request to meet with the Governor's office. The
21 Governor was out of state yesterday and has just
22 returned to the state today.
23 And it's a matter of getting folks who are
24 out of town to come into town as well. So, we are
25 awaiting the scheduling of that.
26 MR. HORTON: Now are --
27 MS. TWOMEY: We think moving forward would
28 be to have the OAL, because they do have -- to

1 transmit it to OAL because they do have thirty days.
2 And we think that within that 30 days we can work
3 towards a resolution.
4 MR. HORTON: And you would be having this
5 conversation with the Governor's Chief of Staff,
6 Ms. McFadden?
7 MS. TWOMEY: Yes.
8 MR. HORTON: She's in town. I think I
9 spoke to her maybe last week. So, she's in town.
10 And you never had this conversation with
11 the Governor before on these particulars?
12 MS. TWOMEY: No, because we -- frankly,
13 this was a surprise to us that Finance would come
14 in, No. 1, a budget agency, to question the legal
15 rulemaking process, which is primarily the
16 jurisdiction of the Office of Administrative Law.
17 It's our understanding this hasn't happened
18 very often. I don't know if it's ever happened in
19 the past. And, so, it's a surprise to us. We
20 weren't informed about it until recently.
21 And, so, as soon as we found out we put a
22 call in and made a request for a meeting with
23 Ms. McFadden.
24 MR. HORTON: Now based on your experience,
25 do think it's a surprise to the Governor's office?
26 MS. TWOMEY: I don't know that the Governor
27 has knowledge of this or even the front office of
28 the Department of Finance.

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1 Based on my reading the letter, it's pretty
2 technical. It's signed by a PBM, which is somebody
3 who's not in the Capitol office -- in the Capitol
4 itself. It's Finance's budget staff, although a
5 manager level. So, I don't know that it's risen to
6 that level.
7 MR. HORTON: Okay, thank you.
8 Member Runner.
9 MR. RUNNER: I was just going to ask,
10 typically -- this can't be the first time that we've
11 created -- had to move forward with a regulation
12 that had an amount of money that was budgeted or a
13 piece of legislation that had an amount of money
14 attached to it over $50 million.
15 In the past when we'd have similar
16 situation -- similar dollars like that, a piece of
17 legislation that had dollars attached to it, did we
18 ever -- did we ever have to do this -- the -- the
19 economic impact in the past?
20 MR. TUCKER: For example --
21 MR. RUNNER: Yes.
22 MR. RUNNER: -- when we implemented the --
23 that regulation itself, 1525.4 --
24 MR. RUNNER: Right.
25 MR. TUCKER: -- we put it forth as zero --
26 MR. RUNNER: Okay.
27 MR. TUCKER: -- impact.
28 MR. RUNNER: Okay. So, that, to me is the

1 point. To me that's a key point because --
2 MR. TUCKER: What we did --
3 MR. RUNNER: -- again, we moved forward
4 with that without having -- having triggered any
5 economic impact. The dollar amount in that
6 legislation was 400 and --
7 MS. TWOMEY: Was $486 million.
8 MR. RUNNER: So -- so, again, it seems to
9 me that this is a different kind of a call -- that
10 we're being asked make here, inconsistent with what
11 we've have done in the past?
12 MR. HORTON: Well --
13 MR. RUNNER: Go ahead. Let me ask --
14 MR. TUCKER: I would agree, I would agree.
15 It's -- as I said, when the initial
16 regulation went through, it was with zero economic
17 impact.
18 MR. RUNNER: And then we weren't -- we
19 weren't required at that point.
20 MR. TUCKER: Well --
21 MR. RUNNER: Obviously, we weren't
22 required.
23 MR. TUCKER: -- it may not have been
24 required at that point, but it's consistent with our
25 view that the economic impact falls back on the
26 statute.
27 MR. RUNNER: In our regulation that we're
28 doing now is basically still --

1 MR. TUCKER: It's an amendment that --
2 MR. RUNNER: -- creating an amendment to
3 that -- that particular item.
4 MR. TUCKER: -- correct.
5 MR. RUNNER: I guess the thing that would
6 make sense to me is if, indeed, our amendment -- or
7 that our amendment to the regulation was going to go
8 over the $450 million, then it would -- then it
9 would seem to me that's -- that's an interesting
10 discussion.
11 But right now we're still -- believe that
12 we're within the amount of dollars within the
13 statute.
14 Okay.
15 MR. TUCKER: It's consistent with how we've
16 done it in the past.
17 MR. RUNNER: Okay, thank you.
18 MR. HORTON: Just to -- my view, from a
19 historical perspective, is -- is that historically
20 none of our regulations have an economic impact
21 greater than what was conceived in the original
22 legislation. So, it's always been zero.
23 And it would only be more than that if, in
24 fact, our actions is causing a greater liability on
25 the state.
26 And that's -- and whenever that occurs,
27 50,000 or not, the legislature's going to say,
28 "You're acting outside your authority," because

1 that's a budgetary thing.
2 And that's what the Department of Finance
3 is saying is that you've got in ex -- we don't know
4 how much, but you've -- we believe you have an
5 excess 50 million in which the -- which the Governor
6 and the legislature have allocated by virtue of this
7 regulation.
8 And, so --
9 MR. RUNNER: I don't think they're saying
10 that. I don't think they're saying that they
11 believe that -- that this $50 million over the
12 $400 million.
13 MR. HORTON: -- what does the expert say?
14 MS. TWOMEY: I don't know what Finance is
15 actually saying, except that they believe there is a
16 cost impact to it.
17 MR. RUNNER: Right.
18 MR. HORTON: But they can't -- I mean, not
19 to create a colloquy, my apologies.
20 If Department of Finance is saying that
21 50 million is within the 490, this is -- they can't
22 object.
23 They -- you know, it's not a major
24 regulation. It's just -- just an amendment to an
25 existing regulation.
26 MR. RUNNER: I think the Chair has hit the
27 core of the discussion.
28 MS. TWOMEY: Yes. And that's why we would

1 like the opportunity to discuss further with, you
2 know, the Governor's office on what it is, because
3 the first year, based on Finance's own number in the
4 bill analysis for the floor statement, they estimate
5 486.
6 But in the second year, which we are now
7 in, they estimate $521 million of utilization. And
8 the utilization will increase in Year 2 and 3.
9 But we won't reach those targeted numbers
10 that Finance put together unless there are some
11 clarifying of the ambiguities.
12 And when we're a quarter below or, excuse
13 me, 75 percent below that target, it's unclear how
14 that is a cost increase.
15 MR. RUNNER: Let me ask -- can I just
16 follow up on that?
17 MR. HORTON: Yeah, sure.
18 MR. RUNNER: Again in the opinion of
19 Cal-Tax, do you believe that -- that moving forward
20 with this amended regulation is going to put us over
21 the amount that was in the original legislation?
22 MS. TWOMEY: Absolutely not.
23 This is one small fix. There are other
24 barriers. I believe that when the legislature
25 looked at the numbers it was based on numbers that
26 we had to get on the data that was available.
27 And the data that was available was based
28 on the MIC, when California had aerospace industry.

1 We had a much larger tech industry.
2 We're not sure that the factors that were
3 discounted in order to derive these estimates took
4 into account that many of those aerospace industries
5 are no longer in California because, you know, the
6 federal government has cut back on its defense
7 budget. Many of those tech companies have relocated
8 and expanded outside the state.
9 So, we think those numbers are
10 overestimated.
11 MR. RUNNER: Thank you.
12 MR. HORTON: Okay. Further discussion,
13 Members?
14 Is there a motion? Member --
15 MS. MA: I was just going to say, I agree.
16 I mean --
17 MR. HORTON: -- Member Ma.
18 MS. MA: -- when we pass legislation in the
19 legislature, sometimes it is not clear. And this is
20 under our purview.
21 And I think to assist taxpayers in trying
22 to figure out if they qualify or not, I think that
23 is within our purview.
24 I also agree with my colleagues that this
25 does not increase costs. This is just clarifying
26 who can and can't file within the guidelines of
27 taking this credit.
28 So, I'm also a little bit confused on why

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1 this would increase costs when, you know, 25 percent
2 of the fund is being used right now because there is
3 so much confusion out there.
4 MR. HORTON: Yeah, I -- I agree with you
5 guys.
6 The challenge I'm having is that they have
7 created this technicality and if we don't -- maybe
8 Mr. Tucker, is there a way that we could -- we
9 could, at least, challenge that by indicating that
10 we believe that -- we believe, based on -- maybe
11 during this time period we could have our economists
12 take a look at it and have some authoritative body
13 within the Board of Equalization, so we can expedite
14 it -- that we believe that this clarification will
15 only allow -- is consistent with what the
16 legislature prescribed relative to the overall cost.
17 MR. TUCKER: My understanding is that a
18 challenge would come after it's been disproved by
19 the OAL. And that's when we'd have the ten-day
20 period.
21 I'm not aware of any means to do so during
22 this process.
23 MR. RUNNER: I would move adoption of the
24 proposed amendments.
25 MR. HORTON: It's been moved by Member
26 Runner, second by Member Ma.
27 Objection noted.
28 Ms. Richmond, call the roll.

1 MS. RICHMOND: Mr. Horton.
2 MR. HORTON: No.
3 MS. RICHMOND: Ms. Harkey.
4 MS. HARKEY: Aye.
5 MS. RICHMOND: Mr. Runner.
6 MR. RUNNER: Aye.
7 MS. RICHMOND: Ms. Ma.
8 MS. MA: Aye.
9 MS. RICHMOND: Ms. Stowers.
10 MS. STOWERS: No.
11 MS. RICHMOND: Motion carries.
12 MR. HORTON: Motion carries.
13 Thank you very much. Appreciate you,
14 Mrs. Twomey, Mr. Tucker, thank you.
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1 REPORTER'S CERTIFICATE

2

3 State of California)

4) ss

5 County of Sacramento)

6

7 I, JULI PRICE JACKSON, Hearing Reporter for

8 the California State Board of Equalization certify

9 that on NOVEMBER 17, 2015 I recorded verbatim, in

10 shorthand, to the best of my ability, the

11 proceedings in the above-entitled hearing; that I

12 transcribed the shorthand writing into typewriting;

13 and that the preceding pages 1 through 27 constitute

14 a complete and accurate transcription of the

15 shorthand writing.

16

17 Dated: DECEMBER 2, 2015

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21 JULI PRICE JACKSON

22 Hearing Reporter

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Electronically signed by Juli Jackson (001-065-206-4972) bee1c38a-f634-4935-a23c-aa147f68b1de

Tuesday, November 17, 2015

The Board recessed at 12:52 p.m. and reconvened at 2:00 p.m. with Mr. Horton, Mr. Runner, Ms. Ma, Ms. Harkey and Ms. Stowers present.

PUBLIC HEARING

Proposed Amendments to Sales and Use Tax Regulation 1525.4, *Manufacturing and Research & Development Equipment*

Robert Tucker, Assistant Chief Counsel, Tax & Fee Programs Division, Legal Department, made introductory remarks regarding proposed amendments clarifying that taxpayers may substantiate the useful life of property using a warranty, service contract, or industry practice (Exhibit 11.4).

Speaker: Therese Twomey, Fiscal Policy Director, California Taxpayers' Association

Action: Upon motion of Mr. Runner, seconded by Ms. Ma and duly carried, Mr. Runner, Ms. Ma and Ms. Harkey voting yes, Mr. Horton and Ms. Stowers voting no, the Board adopted the amendments to Regulation 1525.4 as published.

CORPORATE FRANCHISE AND PERSONAL INCOME TAXES HEARINGS

Maria Phillips (Santamaria-Del Campo) and Michael Del Campo, 741179
2004, $7,782.72 Assessment
2005, $5,918.76 Assessment
2006, $3,517.22 Assessment
2007, $3,933.38 Assessment
For Appellant: Michael Del Campo, Taxpayer
For Franchise Tax Board: Marguerite Mosnier, Tax Counsel
Diane Ewing, Tax Counsel
Contribution Disclosures pursuant to Government Code section 15626: None were disclosed.
Issue: Whether respondent erred in denying appellant innocent spouse relief (ISR) pursuant to Revenue and Taxation Code (R&TC) section 18533, subdivision (f), or relief from joint liability pursuant to R&TC sections 19006, subdivisions (b) or (c), for the 2004, 2005, 2006, and 2007 tax years.
Appellant's Exhibit: Miscellaneous Documents (Exhibit 11.5)
Action: Upon motion of Ms. Stowers, seconded by Ms. Harkey and unanimously carried, Mr. Horton, Mr. Runner, Ms. Ma, Ms. Harkey and Ms. Stowers voting yes, the Board submitted the appeal for decision.

William R. Dobkin and Donya Dobkin, 728014
2006, $181,348.00 Tax, $36,269.60 Accuracy-Related Penalty
Deborah M. Dobkin, 725828
2006, $121,923.00 Tax
For Appellants: William R. Dobkin, Taxpayer
Joseph Mudd, Attorney

STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION
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SEN. GEORGE RUNNER (RET.)
First District, Lancaster

FIONA MA, CPA
Second District, San Francisco

JEROME E. HORTON
Third District, Los Angeles County

DIANE L. HARKEY
Fourth District, Orange County

BETTY T. YEE
State Controller

CYNTHIA BRIDGES
Executive Director

September 25, 2015

To Interested Parties:

Notice of Proposed Regulatory Action

The State Board of Equalization Proposes to Adopt Amendments to 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 amendments to California Code of Regulations, title 18, section (Regulation or Reg.) 1525.4, *Manufacturing and Research & Development Equipment*. The proposed amendments further implement, interpret, and makes specific the "useful life" provisions used in RTC section 6377.1, which provides a 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, by adding clarifying provisions to the regulation expressly permitting taxpayers to substantiate the useful life of otherwise qualified tangible personal property using a warranty, service contract, or industry practice.

PUBLIC HEARING

The Board will conduct a meeting in Room 207 at 5901 Green Valley Circle, Culver City, California, on November 17-19, 2015. 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 9:30 a.m. or as soon thereafter as the matter may be heard on November 17, 18 or 19, 2015. At the hearing, any

interested person may present or submit oral or written statements, arguments, or contentions regarding the adoption of the proposed amendments to 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 (Rev. & Tax. Code (RTC), § 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; Reg. 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, § 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; Regs. 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, the composition of the 7.50 percent rate is discussed in the initial statement of reasons, and the combined tax rate is higher than 7.50 percent 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.).

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 exemption provided by RTC section 6377.1, subdivision (a), is referred to as a partial exemption because RTC section 6377.1, subdivision (d), specifies that the 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; and 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.

RTC section 6377.1, subdivision (a), provides that the partial exemption provided by RTC section 6377.1 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.

As relevant here, RTC section 6377.1, subdivision (b)(7), defines the term "qualified tangible personal property," as follows for purposes of the partial exemption:

> (7)(A) "Qualified tangible personal property" includes, but is not limited to, all of the following:
> (i) Machinery and equipment, including component parts and contrivances such as belts, shafts, moving parts, and operating structures.
> (ii) 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.
> (iii) Tangible personal property used in pollution control that meets standards established by this state or any local or regional governmental agency within this state.
> (iv) 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.
> (B) "Qualified tangible personal property" shall not include any of the following:

> (i) Consumables with a useful life of less than one year.
> (ii) 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.
> (iii) Tangible personal property used primarily in administration, general management, or marketing.

As relevant here, RTC section 6377.1, subdivision (b)(10), defines the term "useful life," which is used in the definition of "qualified tangible personal property." Subdivision (b)(10) provides that "'Useful life' for tangible personal property that is treated 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 section. '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 purposes of this section" (hereafter also referred to as the "deemed" provisions of RTC section 6377.1).

Also, as relevant here, the Legislature intended for the partial exemption provided by RTC section 6377.1 to be fully utilized and, to ensure such utilization, RTC section 6377.1, subdivision (g), provides that:

> (g)(1) Upon the effective date of this section, the Department of Finance shall estimate the total dollar amount of exemptions that will be taken for each calendar year, or any portion thereof, for which this section provides an exemption.
> (2) No later than each March 1 next following a calendar year for which this section provides an exemption, the board shall provide to the Joint Legislative Budget Committee a report of the total dollar amount of exemptions taken under this section for the immediately preceding calendar year. The report shall compare the total dollar amount of exemptions taken under this section for that calendar year with the department's estimate for that same calendar year. If that total dollar amount taken is less than the estimate for that calendar year, the report shall identify options for increasing exemptions taken so as to meet estimated amounts.

In addition, the Board adopted Regulation 1525.4 to have the effect and accomplish the objective of fully implementing, interpreting, and making specific the provisions of RTC section 6377.1 on April 22, 2014, and the regulation became effective on September 25, 2014. As relevant here, Regulation 1525.4, subdivision (b)(9), incorporates the definition of "qualified tangible personal property" from RTC section 6377.1, subdivision (b)(7) (with some minor clarifications that are not relevant here). And, Regulation 1525.4, subdivision (b)(13), incorporates the definition of "useful life" from the "deemed" provisions of RTC section 6377.1, and provides as follows:

> (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.

Furthermore, as relevant here, for federal income tax purposes:

- A taxpayer is generally allowed a current deduction, under Internal Revenue Code (IRC) section 162, for the entire cost of tangible personal property used in a trade or business that has a useful life of 12-months or less;
- A taxpayer is allowed to capitalize the cost of tangible personal property that is used in a trade or business and has a useful life of more than 12 months, and a taxpayer is only generally allowed to annually claim a depreciation deduction for part of the cost of the property (or capital asset) as it is exhausted over its useful life, under IRC section 167; and
- A taxpayer also is generally permitted to "elect" to treat the entire cost of tangible personal property used in a trade or business with a useful life of more than 12 months as a current deduction, under IRC section 179, subject to certain limitations that are not relevant here.

Both California's Personal Income Tax Law (RTC, § 17001 et seq.) and Corporation Tax Law (RTC, § 23001 et seq.) either generally incorporate or contain similar provisions to IRC sections 162, 167, and 179. (See, RTC, §§ 17201, 24343, 24349, 24356, subd. (b)(1)). Therefore, for state franchise and income tax purposes, a qualified person (as defined in RTC, § 6377.1) may treat the entire cost of otherwise qualified tangible personal property with a useful life of exactly one year (or 12 months) as a current deduction, under the provisions of IRC section 162 incorporated into or contained in California law, and may either treat all or a part of the cost of otherwise qualified tangible personal property with a useful life of more than one year (or 12 months) as a current deduction, under the provisions of IRC sections 167 and 179 incorporated into or contained in California law.

<u>Effect, Objective, and Benefits of the Proposed Amendments to Regulation 1525.4</u>

Rulemaking Petition

On Tuesday, July 21, 2015, the Board's Legal Department received a petition dated July 21, 2015, from Ms. Teresa Casazza on behalf of the California Taxpayers Association (CalTax), pursuant to Government Code section 11340.6, requesting that the Board amend Regulation 1525.4 to add clarifying language so that taxpayers may substantiate that tangible personal property satisfies the useful life qualification in RTC section 6377.1 by reference to either warranties, maintenance agreements, or industry replacement standards. The petition explained that:

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.

The attachment to the petition also specifically recommended that the Board amend Regulation 1525.4, subdivision (b)(13), to read as follows:

(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 [personal] 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.

Chief Counsel Memorandum

The Board's Legal Department prepared a Chief Counsel Memorandum dated August 3, 2015, which set forth relevant background information pertaining to the adoption of Regulation 1525.4, provided a discussion of CalTax's petition, and provided Board staff's response. CalTax's petition and Formal Issue Paper 14-001 regarding the Board's adoption of Regulation 1525.4 were also included as attachments to the Chief Counsel Memorandum.

The Chief Counsel Memorandum explained that staff "recognizes that [RTC] 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 [the] '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 [with a useful life of more than one year] 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."

The Chief Counsel Memorandum explained that "CalTax asserts that the explicit language in subdivision (b)(7)(A)(i) makes it clear that the Legislature intended [for the partial exemption to apply to] the component parts and contrivances of machinery and equipment. CalTax further asserts that limiting the [partial] exemption [by narrowly applying] subdivision (b)(10) of that section would needlessly thwart the purpose and intent of RTC section 6377.1."

The Chief Counsel Memorandum also advised the Board, that "[i]f 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, [then,] subject to approval by the Office of Administrative Law [(OAL)], CalTax's requested amendments will address the issues raised by CalTax and effectuate such legislative intent."

August 25, 2015, Board Meeting

The Chief Counsel Memorandum dated August 3, 2015, and CalTax's petition were submitted to the Board Members for consideration during the Board's August 25, 2015, meeting. During the meeting, Board staff introduced the agenda item. Board staff said that, "[a]lthough staff has concerns about the 'deemed' provisions of [RTC] section 6377.1, [staff understands] the perceived ambiguities in the [entire] section's wording and [staff realizes] that reasonable minds may differ on its interpretation." Board staff said that "[i]f the Board agrees, in light of the entire statutory scheme, [that] 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 the approval by [OAL], [Caltax's] proposed amendment[s] will address the issues raised by CalTax and effectuate such legislative intent." Staff also said that staff did not "regard [CalTax's] proposal as having a revenue impact since, subject to the approval by [OAL], [the requested amendments] would be regarded as consistent with the implementing statute." Furthermore, staff said that "for the first year, the [partial] exemption usage was anticipated to be [based on] approximately $15 billion [of expenditures]. However, based upon returns to date, we have [only] seen approximately $3 billion of usage," which may be due to the perceived ambiguities in the statute.

During the discussion of the item, Ms. Therese Twomey, Fiscal Policy Director for CalTax, asked the Board to grant the petition to add the clarifying language to Regulation 1525.4. Ms. Twomey said that "there is ambiguity in the statute," the "ambiguity has prohibited some taxpayers [from qualifying] for the exemption" and, therefore, prevented the partial exemption from generating "the economic activity that was intended by the Legislature" to help increase manufacturing and manufacturing jobs in California. Ms. Twomey also said that CalTax's requested amendments will "allow California taxpayers to better verify and to have the Board substantiate that the 'useful life' language can be substantiated through either a warranty that lasts more than one year, a maintenance contract that lasts more than one year, or industry replacement standards that last for more than one year."

In addition, Ms. Twomey pointed out that RTC section 6377.1, subdivision (g), "itself asks the [Board] to take a look at utilization as well as to compare the utilization to the amount that was estimated, and in the event that that utilization is lower than what is estimated, that the Board make recommendations and pursue changes in order to garner the amount that was initially intended and the economic activity that was intended." She also said that CalTax has "discussed [utilization] with the Department of Finance. And as a matter of fact, they have been asking [CalTax] why utilization is so low" and they are relying on CalTax "to provide the industry's perspective as to why. . . ."

Furthermore, during the discussion of the item, Deputy State Controller Yvette Stowers said that she and State Controller Betty Yee "support having businesses benefit from this exemption and we acknowledge that it is underutilized." However, she also expressed the concern that the

useful life requirement "needs to be fixed in the statute first, as opposed to the regulation" and she said "[f]or that fact" she would "not be voting yes to accept the petition."

In response, Board Chairman Jerome Horton agreed with Ms. Stowers that it would be good to have a statutory fix, but he also expressed serious concerns about the underutilization of the partial exemption and the delays associated with solely pursuing a statutory fix. So, Chairman Horton urged the Board to try to fix the situation by amending the regulation as requested by CalTax.

Also, Board Members George Runner, Diane Harkey and Fiona Ma agreed with Chairman Horton that the Board should try to fix the situation by amending the regulation as requested by CalTax. Both Chairman Horton and Board Member Runner expressed their understanding that OAL would serve as a "backstop" if a statutory fix is legally required before the Board can amend the regulation. And, Board Member Ma explained that, based upon her experience in the Legislature, the Legislature does not have the time to specifically address every regulatory issue in proposed legislation, and the Legislature often enacts legislation with the expectation that the implementing agencies will adopt regulations to address specific regulatory issues when necessary.

At the conclusion of the Board discussion of the item, Chairman Horton and Board Members Harkey, Runner, and Ma voted to grant CalTax's petition and propose the requested amendments to Regulation 1525.4. The Board determined that there is an issue because RTC section 6377.1 does not specify whether a qualified person who currently deducts the entire cost of otherwise qualified tangible personal property that actually has a useful life of one or more years is "treating" such property as having a useful life of less than one year or a useful life of one or more years for state franchise and income tax purposes. RTC section 6377.1 does not expressly state that its "deemed" provisions are the exclusive means by which a qualified person may substantiate that otherwise qualified tangible personal property has a useful life of one or more years for purposes of the partial exemption. RTC section 6377.1 does not provide other reasonable means to establish that otherwise qualified tangible personal property has a useful life of one or more years. And, the lack of specificity creates an ambiguity as to whether it is permissible to use other reasonable methods to substantiate the useful life of otherwise qualified tangible personal property under the statute. The Board also determined that the amendments requested in CalTax's petition are reasonably necessary to have the effect and accomplish the objective of addressing the issue created by the ambiguity in the statute by adding clarifying provisions to the regulation expressly permitting taxpayers to substantiate the useful life of otherwise qualified tangible personal property using other reasonable means, including a warranty, service contract, or industry practice.

The Board anticipates that the proposed amendments will benefit qualified persons who deduct, rather than capitalize, the cost of otherwise qualified tangible personal property on their state franchise and income tax returns by clarifying that they may substantiate that such property satisfies the "useful life" requirements for the partial exemption provided by RTC section 6377.1 using a warranty, service contract, or industry practice. The Board anticipates that the proposed

amendments will benefit all taxpayers by promoting fairness and helping ensure that similarly situated taxpayers, such as Taxpayer A and Taxpayer B referred to in CalTax's petition, do not receive disparate treatment. The Board also anticipates that the proposed amendments will generally benefit the people of the State of California by helping ensure that the partial exemption provided by RTC section 6377.1 is utilized as originally anticipated by the Legislature and that the statute increases manufacturing and manufacturing jobs in California as the Legislature intended.

The Board has performed an evaluation of whether the proposed amendments to Regulation 1525.4 are inconsistent or incompatible with existing state regulations and determined that the proposed amendments are not inconsistent or incompatible with existing state regulations. This is because Regulation 1525.4 is the only state regulation that specifically implements, interprets, and makes specific the provisions of RTC section 6377.1, and the proposed amendments to Regulation 1525.4 clarify and are consistent with the regulation's current provisions. In addition, the Board has determined that there are no comparable federal regulations or statutes to Regulation 1525.4 or the proposed amendments to Regulation 1525.4.

NO MANDATE ON LOCAL AGENCIES OR SCHOOL DISTRICTS

The Board has determined that the adoption of the proposed amendments to 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 the proposed amendments to 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 the proposed amendments to 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 the proposed amendments to 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.

The adoption of the proposed amendments to Regulation 1525.4 may affect small business.

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 amendments to Regulation 1525.4 are 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 the proposed amendments to 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 the proposed amendments to 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 the proposed amendments to 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 amendments should be directed to Bradley M. Heller, Tax Counsel IV, by telephone at (916) 323-3091, by e-mail at Bradley.Heller@boe.ca.gov, or by mail at State Board of Equalization, Attn: Bradley Heller, 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. Mr. Bennion is the designated backup contact person to Mr. Heller.

WRITTEN COMMENT PERIOD

The written comment period ends at 9:30 a.m. on November 17, 2015, or as soon thereafter as the Board begins the public hearing regarding the proposed amendments to Regulation 1525.4 during the November 17-19, 2015, 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 the proposed amendments to 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 the proposed amendments to Regulation 1525.4 and the additions to the regulation are underlined in the text. The Board has also prepared an initial statement of reasons for the adoption of the proposed amendments to Regulation 1525.4, 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 amendments are 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 amendments 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 the proposed amendments to 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 amendments, with the change clearly indicated, available to the public for at least 15 days before adoption. The text of the proposed amendments, with the change clearly indicated, will be mailed to those interested parties who commented on the original proposed amendments orally or in writing or who asked to be informed of such changes. The text of the proposed amendments, with the change clearly indicated, will also be available to the public from Mr. Bennion. The Board will consider written comments regarding the

sufficiently related change that are received prior to the Board's adoption of the resulting regulation.

EFFECTIVE DATE

The Board is proposing to adopt amendments to Regulation 1525.4 to further implement, interpret, and make specific the partial exemption from sales and use tax provided by RTC section 6377.1. The partial exemption became effective on July 1, 2014, and is not being utilized as anticipated and intended by the Legislature, which may be due to the ambiguity in RTC section 6377.1 that the amendments are intended to clarify. Also, once the proposed amendments are effective, the clarification 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 the proposed clarifying amendments to Regulation 1525.4 in order to help ensure that the partial exemption begins to be utilized as originally anticipated and intended by the Legislature, as soon as possible, and the Board may request an early effective date for the proposed amendments to Regulation 1525.4, pursuant to Government Code section 11343.4, subdivision (b)(3).

AVAILABILITY OF FINAL STATEMENT OF REASONS

If the Board adopts the proposed amendments to 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

Initial Statement of Reasons for
Proposed Amendments to California Code of Regulations, Title 18, Section 1525.4, *Manufacturing and Research & Development Equipment*

SPECIFIC PURPOSE, PROBLEM 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), § 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, § (Regulation or Reg. 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, § 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; Regs. 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 exemption provided by RTC section 6377.1, subdivision (a), is referred to as a partial exemption because RTC section 6377.1, subdivision (d), specifies that the 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; and 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.

RTC section 6377.1, subdivision (a), provides that the partial exemption provided by RTC section 6377.1 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.

As relevant here, RTC section 6377.1, subdivision (b)(7), defines the term "qualified tangible personal property," as follows for purposes of the partial exemption:

> (7)(A) "Qualified tangible personal property" includes, but is not limited to, all of the following:

(i) Machinery and equipment, including component parts and contrivances such as belts, shafts, moving parts, and operating structures.
(ii) 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.
(iii) Tangible personal property used in pollution control that meets standards established by this state or any local or regional governmental agency within this state.
(iv) 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.
(B) "Qualified tangible personal property" shall not include any of the following:
(i) Consumables with a useful life of less than one year.
(ii) 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.
(iii) Tangible personal property used primarily in administration, general management, or marketing.

As relevant here, RTC section 6377.1, subdivision (b)(10), defines the term "useful life," which is used in the definition of "qualified tangible personal property." Subdivision (b)(10) provides that "'Useful life' for tangible personal property that is treated 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 section. '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 purposes of this section" (hereafter also referred to as the "deemed" provisions of RTC section 6377.1).

Also, as relevant here, the Legislature intended for the partial exemption provided by RTC section 6377.1 to be fully utilized and, to ensure such utilization, RTC section 6377.1, subdivision (g), provides that:

(g)(1) Upon the effective date of this section, the Department of Finance shall estimate the total dollar amount of exemptions that will be taken for each calendar year, or any portion thereof, for which this section provides an exemption.
(2) No later than each March 1 next following a calendar year for which this section provides an exemption, the board shall provide to the Joint

> Legislative Budget Committee a report of the total dollar amount of exemptions taken under this section for the immediately preceding calendar year. The report shall compare the total dollar amount of exemptions taken under this section for that calendar year with the department's estimate for that same calendar year. If that total dollar amount taken is less than the estimate for that calendar year, the report shall identify options for increasing exemptions taken so as to meet estimated amounts.

In addition, the Board adopted Regulation 1525.4, *Manufacturing and Research & Development Equipment*, for the specific purpose of fully implementing, interpreting, and making specific the provisions of RTC section 6377.1 on April 22, 2014, and the regulation became effective on September 25, 2014. As relevant here, Regulation 1525.4, subdivision (b)(9), incorporates the definition of "qualified tangible personal property" from RTC section 6377.1, subdivision (b)(7) (with some minor clarifications that are not relevant here). And, Regulation 1525.4, subdivision (b)(13), incorporates the definition of "useful life" from the "deemed" provisions of RTC section 6377.1, and provides as follows:

> (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.

Furthermore, as relevant here, for federal income tax purposes:

- A taxpayer is generally allowed a current deduction, under Internal Revenue Code (IRC) section 162, for the entire cost of tangible personal property used in a trade or business that has a useful life of 12-months or less;
- A taxpayer is allowed to capitalize the cost of tangible personal property that is used in a trade or business and has a useful life of more than 12 months, and a taxpayer is only generally allowed to annually claim a depreciation deduction for part of the cost of the property (or capital asset) as it is exhausted over its useful life, under IRC section 167; and
- A taxpayer also is generally permitted to "elect" to treat the entire cost of tangible personal property used in a trade or business with a useful life of more than 12 months as a current deduction, under IRC section 179, subject to certain limitations that are not relevant here.

Both California's Personal Income Tax Law (RTC, § 17001 et seq.) and Corporation Tax Law (RTC, § 23001 et seq.) either generally incorporate or contain similar provisions to IRC sections 162, 167, and 179. (See, RTC, §§ 17201, 24343, 24349, 24356, subd. (b)(1)). Therefore, for state franchise and income tax purposes, a qualified person (as

defined in RTC, § 6377.1) may treat the entire cost of otherwise qualified tangible personal property with a useful life of exactly one year (or 12 months) as a current deduction, under the provisions of IRC section 162 incorporated into or contained in California law, and may either treat all or a part of the cost of otherwise qualified tangible personal property with a useful life of more than one year (or 12 months) as a current deduction, under the provisions of IRC sections 167 and 179 incorporated into or contained in California law.

Proposed Amendments

Rulemaking Petition

On Tuesday, July 21, 2015, the Board's Legal Department received a petition dated July 21, 2015, from Ms. Teresa Casazza on behalf of the California Taxpayers Association (CalTax), pursuant to Government Code section 11340.6, requesting that the Board amend Regulation 1525.4 to add clarifying language so that taxpayers may substantiate that tangible personal property satisfies the useful life qualification in RTC section 6377.1 by reference to either warranties, maintenance agreements, or industry replacement standards. The petition explained that:

> 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.

The attachment to the petition also specifically recommended that the Board amend Regulation 1525.4, subdivision (b)(13), to read as follows:

(13)(A)[1] "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 personal[2] 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.

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[1] The attachment illustrated the requested amendments in italics, and they are shown here in underline.
[2] The attachment inadvertently omitted the word "personal" from the text of proposed subdivision (b)(13)(B)1.

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.

Chief Counsel Memorandum

The Board's Legal Department prepared a Chief Counsel Memorandum dated August 3, 2015, which set forth relevant background information pertaining to the adoption of Regulation 1525.4, provided a discussion of CalTax's petition, and provided Board staff's response. CalTax's petition and Formal Issue Paper 14-001 regarding the Board's adoption of Regulation 1525.4 were also included as attachments to the Chief Counsel Memorandum.

The Chief Counsel Memorandum explained that staff "recognizes that [RTC] 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 [the] '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 [with a useful life of more than one year] 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."

The Chief Counsel Memorandum explained that "CalTax asserts that the explicit language in subdivision (b)(7)(A)(i) makes it clear that the Legislature intended [for the partial exemption to apply to] the component parts and contrivances of machinery and equipment. CalTax further asserts that limiting the [partial] exemption [by narrowly applying] subdivision (b)(10) of that section would needlessly thwart the purpose and intent of RTC section 6377.1."

The Chief Counsel Memorandum also advised the Board, that "[i]f 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, [then,] subject to approval by the Office of Administrative Law [(OAL)], CalTax's requested amendments will address the issues raised by CalTax and effectuate such legislative intent."

August 25, 2015, Board Meeting

The Chief Counsel Memorandum dated August 3, 2015, and CalTax's petition were submitted to the Board Members for consideration during the Board's August 25, 2015, meeting. During the meeting, Board staff introduced the agenda item. Board staff said that, "[a]lthough staff has concerns about the 'deemed' provisions of [RTC] section 6377.1, [staff understands] the perceived ambiguities in the [entire] section's wording and [staff realizes] that reasonable minds may differ on its interpretation." Board staff said that "[i]f the Board agrees, in light of the entire statutory scheme, [that] 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 the approval by [OAL], [Caltax's] proposed amendment[s] will address the issues raised by CalTax and effectuate such legislative intent." Staff also said that staff did not "regard [CalTax's] proposal as having a revenue impact since, subject to the approval by [OAL], [the requested amendments] would be regarded as consistent with the implementing statute." Furthermore, staff said that "for the first year, the [partial] exemption usage was anticipated to be [based on] approximately $15 billion [of expenditures]. However, based upon returns to date, we have [only] seen approximately $3 billion of usage," which may be due to the perceived ambiguities in the statute.

During the discussion of the item, Ms. Therese Twomey, Fiscal Policy Director for CalTax, asked the Board to grant the petition to add the clarifying language to Regulation 1525.4. Ms. Twomey said that "there is ambiguity in the statute," the "ambiguity has prohibited some taxpayers [from qualifying] for the exemption" and, therefore, prevented the partial exemption from generating "the economic activity that was intended by the Legislature" to help increase manufacturing and manufacturing jobs in California. Ms. Twomey also said that CalTax's requested amendments will "allow California taxpayers to better verify and to have the Board substantiate that the 'useful life' language can be substantiated through either a warranty that lasts more than one year, a maintenance contract that lasts more than one year, or industry replacement standards that last for more than one year."

In addition, Ms. Twomey pointed out that RTC section 6377.1, subdivision (g), "itself asks the [Board] to take a look at utilization as well as to compare the utilization to the amount that was estimated, and in the event that that utilization is lower than what is estimated, that the Board make recommendations and pursue changes in order to garner the amount that was initially intended and the economic activity that was intended." She also said that CalTax has "discussed [utilization] with the Department of Finance. And as a matter of fact, they have been asking [CalTax] why utilization is so low" and they are relying on CalTax "to provide the industry's perspective as to why. . . ."

Furthermore, during the discussion of the item, Deputy State Controller Yvette Stowers said that she and State Controller Betty Yee "support having businesses benefit from this exemption and we acknowledge that it is underutilized." However, she also expressed the concern that the useful life requirement "needs to be fixed in the statute first, as opposed to the regulation" and she said "[f]or that fact" she would "not be voting yes to accept the petition."

In response, Board Chairman Jerome Horton agreed with Ms. Stowers that it would be good to have a statutory fix, but he also expressed serious concerns about the underutilization of the partial exemption and the delays associated with solely pursuing a statutory fix. So, Chairman Horton urged the Board to try to fix the situation by amending the regulation as requested by CalTax.

Also, Board Members George Runner, Diane Harkey and Fiona Ma agreed with Chairman Horton that the Board should try to fix the situation by amending the regulation as requested by CalTax. Both Chairman Horton and Board Member Runner expressed their understanding that OAL would serve as a "backstop" if a statutory fix is legally required before the Board can amend the regulation. And, Board Member Ma explained that, based upon her experience in the Legislature, the Legislature does not have the time to specifically address every regulatory issue in proposed legislation, and the Legislature often enacts legislation with the expectation that the implementing agencies will adopt regulations to address specific regulatory issues when necessary.

At the conclusion of the Board discussion of the item, Chairman Horton and Board Members Harkey, Runner, and Ma voted to grant CalTax's petition and propose the

requested amendments to Regulation 1525.4. The Board determined that there is an issue (or problem within the meaning of Gov. Code, 11346.2, subd. (b)) because RTC section 6377.1 does not specify whether a qualified person who currently deducts the entire cost of otherwise qualified tangible personal property that actually has a useful life of one or more years is "treating" such property as having a useful life of less than one year or a useful life of one or more years for state franchise and income tax purposes. RTC section 6377.1 does not expressly state that its "deemed" provisions are the exclusive means by which a qualified person may substantiate that otherwise qualified tangible personal property has a useful life of one or more years for purposes of the partial exemption. RTC section 6377.1 does not provide other reasonable means to establish that otherwise qualified tangible personal property has a useful life of one or more years. And, the lack of specificity creates an ambiguity as to whether it is permissible to use other reasonable methods to substantiate the useful life of otherwise qualified tangible personal property under the statute. The Board also determined that the amendments requested in CalTax's petition are reasonably necessary for the specific purpose of addressing the issue (or problem) created by the ambiguity in the statute by adding clarifying provisions to the regulation expressly permitting taxpayers to substantiate the useful life of otherwise qualified tangible personal property using other reasonable means, including a warranty, service contract, or industry practice.

The Board anticipates that the proposed amendments will benefit qualified persons who deduct, rather than capitalize, the cost of otherwise qualified tangible personal property on their state franchise and income tax returns by clarifying that they may substantiate that such property satisfies the "useful life" requirements for the partial exemption provided by RTC section 6377.1 using a warranty, service contract, or industry practice. The Board anticipates that the proposed amendments will benefit all taxpayers by promoting fairness and helping ensure that similarly situated taxpayers, such as Taxpayer A and Taxpayer B referred to in CalTax's petition, do not receive disparate treatment. The Board also anticipates that the proposed amendments will generally benefit the people of the State of California by helping ensure that the partial exemption provided by RTC section 6377.1 is utilized as originally anticipated by the Legislature and that the statute increases manufacturing and manufacturing jobs in California as the Legislature intended.

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

DOCUMENTS RELIED UPON

The Board relied upon the Chief Counsel Memorandum dated August 3, 2015, the attachments to the memorandum, including CalTax's petition, and the comments made during the Board's discussion of CalTax's petition during its August 25, 2015, Board meeting in deciding to propose the amendments to Regulation 1525.4, described above.

ALTERNATIVES CONSIDERED

The Board considered whether to deny CalTax's petition, propose to adopt CalTax's requested amendments to Regulation 1525.4 in whole or in part, or take other appropriate action during its meeting on August 25, 2015. During the meeting, the Board decided to propose to adopt all of the amendments to Regulation 1525.4 requested by CalTax because the Board determined that the adoption of the proposed amendments is reasonably necessary for the reasons provided above.

The Board did not reject any reasonable alternative to the proposed amendments to 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)

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. Also, as explained above, the Legislature intended for the partial exemption provided by RTC section 6377.1 to be fully utilized and, to ensure such utilization, RTC section 6377.1, subdivision (g), required the Department of Finance to estimate the total dollar amount of exemptions that will be taken for each calendar year the partial exemption will be in effect and requires the Board to annually report the total dollar amount of exemptions taken for the immediately preceding calendar year, compare the total dollar amount of those exemptions to the Department of Finance's estimate for that same year, and identify options for increasing exemptions taken so as to meet the Department of Finance's estimates when necessary. And, the Board anticipates that RTC section 6377.1 will continue to have an economic impact on business and state revenue as intended the Legislature intended.

As explained in more detail above, RTC section 6377.1, subdivision (b)(7), requires that tangible personal property have a useful life of one or more years in order for that property to be "qualified tangible personal property" for purposes of the partial exemption, and RTC section 6377.1, subdivision (b)(10), provides that: "'Useful life' for tangible personal property that is treated 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 section. '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 purposes of this section."

The Board has determined that there is an issue because RTC section 6377.1 does not specify whether a qualified person who currently deducts the entire cost of otherwise qualified tangible personal property that actually has a useful life of one or more years is "treating" such property as having a useful life of less than one year or a useful life of one or more years for state franchise and income tax purposes. RTC section 6377.1 does not expressly state that its "deemed" provisions are the exclusive means by which a qualified person may substantiate that otherwise qualified tangible personal property has a useful life of one or more years for purposes of the partial exemption. RTC section 6377.1 does not provide other reasonable means to establish that otherwise qualified tangible personal property has a useful life of one or more years. And, the lack of specificity creates an ambiguity as to whether it is permissible to use other reasonable methods to substantiate the useful life of otherwise qualified tangible personal property under the statute. The Board also determined that the amendments to Regulation 1525.4 requested in CalTax's petition (discussed above) are reasonably necessary for the specific purpose of addressing the issue created by the ambiguity in the statute by adding clarifying provisions to the regulation expressly permitting taxpayers to substantiate the useful life of otherwise qualified tangible personal property using other reasonable means, including a warranty, service contract, or industry practice.

The Board anticipates that the proposed amendments will benefit qualified persons who deduct, rather than capitalize, the cost of otherwise qualified tangible personal property on their state franchise and income tax returns by clarifying that they may substantiate that such property satisfies the "useful life" requirements for the partial exemption provided by RTC section 6377.1 using a warranty, service contract, or industry practice. The Board anticipates that the proposed amendments will benefit all taxpayers by promoting fairness and helping ensure that similarly situated taxpayers, such as Taxpayer A and Taxpayer B referred to in CalTax's petition, do not receive disparate treatment. The Board also anticipates that the proposed amendments will generally benefit the people of the State of California by helping ensure that the partial exemption provided by RTC section 6377.1 is utilized as originally anticipated by the Legislature and that the statute increases manufacturing and manufacturing jobs in California as the Legislature intended.

The Board has also determined that the proposed amendments to Regulation 1525.4 are fully consistent with current law, including RTC section 6377.1, subject to OAL approval, and there is nothing in the proposed amendments that would significantly change how the Legislature intended for individuals and businesses to behave in response to RTC section 6377.1. Therefore, the Board estimates that the proposed amendments, themselves, 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 amendments to Regulation 1525.4 are 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 amendments 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 the proposed amendments to Regulation 1525.4 do 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 the proposed amendments to 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 the proposed amendments to 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, Regulation 1525.4 does 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 the proposed amendments to 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 the proposed amendments to Regulation 1525.4 will not have a significant adverse economic impact on business.

The adoption of the proposed amendments to Regulation 1525.4 may affect small businesses.

Text of Proposed Amendments to

California Code of Regulations, Title 18, Section 1525.4,

Manufacturing and Research & Development Equipment

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.
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> 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 personal 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.

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: Bradley Heller
Legal Contact: Bradley Heller

The State Board of Equalization proposes to adopt amendments to Sales and Use Tax Regulation 1525.4, *Manufacturing and Research & Development Equipment*, to clarifying that taxpayers may substantiate the useful life of otherwise qualified tangible personal property using a warranty, service contract, or industry practice

History of Proposed Regulation:

November 17-19, 2015	Public Hearing
September 25, 2015	OAL publication date; 45-day public comment period begins; Interested Parties mailing
September 15, 2015	Notice to OAL
August 25, 2015	Chief Counsel Matters, Board Authorized Publication (Vote 4-1)

Sponsor:	NA
Support:	NA
Oppose:	NA