



STATE BOARD OF EQUALIZATION

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April 4, 1996

Mr. K--- N. K---
Manager, Planning & Finance
K--- F---, Inc.
P.O. Box XX
---, --- XXXXX

E. L. Sorensen, Jr.
Executive Director

Re: K--- F---, Inc.

Dear Mr. K---:

This is in response to your letter dated March 7, 1996 requesting a written opinion as to whether K--- F---, Inc. ("KFI") qualifies for the Revenue and Taxation Code section 6377 partial sales and use tax exemption.

You state:

"K--- Foods, Inc. (KFI), a --- corporation, is a soy sauce manufacturer with a single manufacturing facility in the United States, located in ---, ---. It is a wholly owned subsidiary of K--- Corporation, a Japanese corporation.

"KFI manufactures soy sauce and soy sauce related products and sells a majority of its product to K--- I--- Inc. (KII), a related party as defined in section 267 of the Internal Revenue Code. KII, a California corporation, is headquartered in --- -, California and has two branch sales offices located in --- --- and --- ---. KFI sells to KII at a price sufficient to satisfy an arms length result in accordance with section 482 of the Internal Revenue Code. KFI and KII management are separate and autonomous.

"KFI is engaged in a manufacturing line of business as described in Code 2035 of the Standard Industrial Classification (SIC) Manual. KII is engaged in a wholesale trade as defined in Code 5140 of the SIC Manual.

"....

"KFI presently does not have any nexus nor does it engage in any business in the state of California.

“KFI is considering whether to locate and build a second manufacturing facility in Northern California. All manufacturing equipment purchased for a California facility will be delivered and installed in California.

“KFI will continue to sell the majority of its product to KII.

“In addition to purchases from KFI, KII has a production agreement with a spice manufacturer, M--- & Co., Inc. [“M---”] for the manufacture of spice mixes and a packaging agreement with S--- F---, Inc. [“S---”] for the packaging of same spice mixes. Sales of spice mixes account for approximately 1-2% of KII’s annual revenue. 98-99% of its sales are products for resale. Therefore, KII’s significant economic activity is a wholesale trade as defined under Code 5140 of the SIC manual.”

You ask whether KFI may qualify for the partial sales and use tax exemption based on the above facts.¹

Discussion

Before answering your specific inquiry, a brief overview of the section 6377 partial sales and use tax exemption (hereafter referred to as “the partial sales and use tax exemption”) is necessary to facilitate our response. Revenue and Taxation Code section 6377² was originally enacted by SB 671. The SB 671 version of section 6377 provided an exemption from the state component of the sales and use tax, which is imposed at the rate of 6 percent. Section 6377 was thereafter amended by the passage of SB 676, which became operative on January 1, 1995. As of January 1, 1995, the partial sales and use tax exemption provided by section 6377 was significantly revised which, among other things, reduced the exemption to tax imposed of 5 percent. Thus, if a sale meeting the requirements of the section 6377 partial exemption occurred in 1994 in a district where the sales tax rate is 7-3/4 percent, tax of 1-3/4 percent would be due. If a qualifying sale occurs in that district in 1995, tax of 2-3/4 percent is due.

Pursuant to the SB 676 version of section 6377, the partial sales and use tax exemption generally applies to persons that commence a new trade or business on or after January 1, 1994 inside this state which is described in codes 2000 to 3999 of the 1987 SIC manual. A person meeting these requirements is a “qualified person”; however, a qualified person does not include a person who undertakes a manufacturing activity inside this state within the same SIC code division as a prior trade or business operated by that person (or any related person within the

¹ We note that your letter sets forth two separate issues: 1) “Will KFI be a ‘qualified person’ commencing a ‘new business’ for purposes of the partial manufacturing exemption if it builds a manufacturing facility in California?”; and, 2) “Does KII’s (the related wholesale company) activities impact whether KFI is a ‘qualified person’ commencing a ‘new business’ for purposes of the partial manufacturing exemption?” These two issues may not be separately answered under the facts you have presented since a response to issue one is dependent on our response to issue two. We have therefore combined both of your “issues” into the single question of whether KFI may qualify for the partial sales and use tax exemption.

² All further references are to the Revenue and Taxation Code unless otherwise noted.

meaning of sections 267 and 318 of the Internal Revenue Code) inside this state within the previous 36 months. The partial sales and use tax exemption generally applies to the sale or use of tangible personal property used primarily for manufacturing, processing, refining, fabricating, recycling, research and development and the repair of qualified property.

Section 6377 makes a distinction between persons who are or were previously engaged in a trade or business inside this state and those that are not for purposes of determining “qualified person” status. A new trade or business is generally one which a person (or any related person) has not engaged in within the preceding 36 months inside this state or which is classified in a different SIC code division³ than that person's (or any related person's) current or prior trade or business activities in this state. (Rev. & Tax. Code § 6377(b)(5)(A)(ii).) This means that a person currently or previously engaged in a trade or business activity in this state within the preceding 36 months is a “qualified person” only if that person's (or related person's) current or previous activity is in a non-division D SIC code activity and that person undertakes a new trade or business activity in California described in division D of the SIC manual. On the other hand, persons engaged in a trade or business activity wholly outside the state who commence doing business in California on or after January 1, 1994 qualify as a new trade or business regardless of that person's prior trade or business activity outside California. (See Rev. & Tax. Code § 6377(b)(5)(A)(iii).) Under either scenario, the new trade or business must commence such operations inside this state on or after January 1, 1994. (Reg. 1525.2(c)(5)(A).) We generally regard business operations to begin upon the acquisition of operating assets that are necessary to the type of business contemplated. (See Reg. 1525.2(c)(5)(A)1.)⁴

As an alternate to the partial sales and use tax exemption, SB 676 provides a manufacturer's investment credit (“MIC”) (see Rev. & Tax. Code §§ 17053.49, 23649) for purchases of certain qualified property by persons engaged in those lines of business described in SIC code 2000 to 3999. The MIC is 6 percent (1 percent higher than the partial sales and use tax exemption contained in SB 676) and is allowed only where the qualified taxpayer does not elect to take the partial exemption. (See Rev. & Tax. Code §§ 17053.49(a)(1); (b)(1)(B); 23649(a)(1); (b)(1)(B).) Questions regarding the application of the MIC should be addressed to the Franchise Tax Board - Legal Division, P.O. Box 1468, Sacramento, California 95812-1468.

You state that KFI presently manufactures food products exclusively outside California and that it wishes to begin manufacturing operations inside this state described in code 2035 of the SIC manual. You also state that KFI and KII are related persons within the meaning of Internal Revenue Code sections 267 and that KII has been previously engaged in some form of business operations inside this state within the previous 36 months. As such, KFI will qualify as a “new trade or business” only where it meets the following provisions of section 6377(b)(5)(A)(ii):

³ The SIC code division is the largest classification standard within the SIC manual. The SIC manual defines business establishments from their broadest to smallest classifications as follows: division, major group, industry group, and industry code. For example, SIC code division D contains SIC industry codes 2000 through 3999.

⁴ “New trade or business” status is further limited in situations where a person acquired the assets of another business. (See Rev. & Tax. Code § 6377(b)(5)(A)(i) et seq.) We have not discussed these provisions since you do not indicate that KFI acquired the assets of another business.

“In any case where a person (or related person) is engaged in one or more trade or business activities in this state, or has been engaged in one or more trade or business activities in this state within the preceding 36 months (‘prior trade or business activity’), and thereafter commences an additional trade or business activity in this state, the additional trade or business activity shall be treated as a new business if the additional trade or business activity is classified under a different division of the Standard Industrial Classification Manual published by the United States Office of Management and Budget, 1987 edition, than are any of the person’s (or any related person’s) current or prior trade or business activities in this state.”

In other words, both KFI and KII must not be regarded as having engaged in a manufacturing activity inside this state within the 36 months preceding the time KFI engages in a manufacturing operation inside this state in order for that operation to qualify for the partial sales and use tax exemption. (See also Reg. 1525.2(c)(5)(A)(4).) We have therefore analyzed the operations of KII below for purposes of determining whether KFI is regarded as having undertaken a manufacturing operation inside this state within the previous 36 months.

KII Production Agreement

You state that KFI’s related person, KII, has a production agreement with M--- for the manufacture of spice mixes and a packaging agreement with S--- for the packaging of these same spice mixes. It is unclear from your letter, however, to what extent, if any, KII is involved in the manufacture and packaging of these spices.⁵ For purposes of this opinion, we assume that KII’s operations with M--- and S--- are wholesale activities generally consisting of “the breaking of bulk and redistribution in smaller lots, including packaging and repackaging ...” (see SIC manual at p. 68) and are not manufacturing operations generally consisting of the “mechanical or chemical transformation of materials or substances into new products” (*Id.* at p. 67). Under these facts, KFI is not precluded from qualifying as a new trade or business for purposes of the partial sales and use tax exemption provided KII’s operations are in fact wholesale and not manufacturing activities.

KII Sales Operations

⁵ You do not provide us with copies of the production and packaging agreement between KII and M--- and KII and S---. We are therefore unable to provide you with a conclusive opinion as to whether KII’s operations inside this state constitute a manufacturing operation. Instead, we are only able to comment on this particular issue based on your representation of facts and the assumptions we derive or supply based on your representations. We cannot guarantee that, upon audit, a Board Auditor would not disagree with the facts as you have presented or the assumption(s) we have made on this issue.

You state that KII is headquartered in --- --- and has two branch sales offices located in --- --- and --- ---. Under an earlier draft of Regulation 1525.2(c)(5)(A)3, a person was regarded as having conducted a manufacturing operation inside this state if it merely operated a warehouse or sales office inside this state for its out-of-state manufacturing operation.⁶ Language reflecting this position was not, however, adopted by the Board in the final version of Regulation 1525.2(c)(5)(A)3⁷ and is not therefore a condition for qualifying as a new trade or business. Thus, a person is regarded as having undertaken a manufacturing operation in California only if it actually engaged in a business operation described in SIC codes 2000 to 3999 inside this state.

We understand that KII is not engaged in a manufacturing operation defined in division D of the SIC code. (See our discussion under “KII Production Agreement” above.) We also understand from your letter that KII’s operations fall within SIC division F,⁸ code 5149, “Groceries and Related Products, Not Elsewhere Classified.”⁹ As such, corporation KII’s activities inside this state do not constitute a manufacturing operation by KFI. This means that KFI is not precluded from qualifying as a “new trade or business” based on the past or current operations of KII inside this state.

* * * * *

This letter is based upon the facts and representations set forth in you letter, and the assumptions reflected herein. If the actual facts and circumstances differ from those set forth in your letter, or those reflected herein, then our opinion likewise might be different. If you have any further questions, please write again.

Sincerely,

Warren L. Astleford
Staff Counsel

WLA:rz

⁶ An earlier draft of Regulation 1525.2(c)(5)(A)3 contained the following additional language:

“A manufacturer may be considered to have conducted activities in a manufacturing trade or business in this state even if that manufacturer has never operated a manufacturing plant here, but, instead, has only operated a warehouse or sales office in this state.”

⁷ The final adopted version of Regulation 1525.2(c)(5)(A)3 reads:

“A trade or business is not a new trade or business in this state if, within the 36 months preceding the date that activities were first commenced in that trade or business in this state, either the person claiming the partial exemption, or any related person, had conducted any activities in this state in any trade or business classified under the same division of the Manual as that trade or business.”

⁸ Division F contains SIC codes 5012 through 5199.

⁹ SIC code 5149 is generally defined as “Establishments primarily engaged in the wholesale distribution of groceries and related products, not elsewhere classified.”

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May 9, 1996

VIA FACSIMILE AND U.S. MAIL

E. L. Sorensen, Jr.
Executive Director

Mr. K--- N. K---
Manager, Planning & Finance
K--- F---, Inc.
P.O. Box XX
---, --- XXXXX

Re: K--- F---, Inc.

Dear Mr. K---:

This is in response to your letter dated April 26, 1996 requesting a conclusive opinion as to whether K--- F---, Inc. ("KFI") qualifies for the Revenue and Taxation Code section 6377 partial sales and use tax exemption (hereafter referred to as "the partial sales and use tax exemption") based on additional information provided in your letter. Our previous letter dated April 4, 1996 concluded that KFI qualified for the partial sales and use tax exemption based on certain assumptions we provided about K--- I--- Inc.'s ("KII") operations inside this state and KII's contractual relationships with M--- & Co., Inc. ("M---") and S--- F---, Inc. ("S---"). Our opinion below supersedes and replaces those portions of our previous letter dated April 4, 1996 under the heading "KII Production Agreement." The remaining portions of our April 4, 1996 letter are incorporated by reference into our opinion below.

With regard to KII's operations, you state:

"KII ... supplies dehydrated powdered soy sauce to a ... M--- production facility located in Northern California. Under a production agreement with KII ..., M--- (formerly St---) manufactures powdered oriental spice mixes using powdered soy sauce as a primary ingredient combined with other ingredients supplied by KII, including ginger and oyster extract. McCormick ships the resulting bulk spice mix to a KII designee, S--- ... also located in California. Under an agreement with KII ..., S--- ... breaks this bulk and packages it into smaller lots. KII then ships this packaged product to a rented warehouse for distribution and sale."

You also state:

“(1) While the agreement between KII and M--- states that M--- manufactures spice mixes exclusively for KII, M--- has represented to us that it has similar agreements with other customers. In addition, M--- determines its price to KII using pricing methods common to other customers and to the spice manufacturing industry in general. Therefore, it appears that M--- enters into exclusive production arrangements in the ordinary course of doing business.

“(2) KII does not employ anyone nor does it invest in any capital equipment at the M--- production facility....

“As an aside, KII headquarters (KII-HQ) located in --- --- employs one person - out of a total of forty-one - to coordinate spice mix production with M---. Forty employees at KH-HQ are engaged in a wholesale activity as defined under Code 5149 of the SIC manual....

“(3) According to M---, sales to KII under this agreement represent approximately 1% by volume of its 1995 California manufacturing output. All sales are FOB-destination with M--- assuming all of the risk of loss or damage.

“(4) M--- also purchases powdered soy sauce from KII for production of spice mixes for other than M--- customers.”

You ask whether KII is “deemed a manufacturer in the State of California because of its agreement with M--- [and S---] and, therefore, is KFI precluded from qualifying as a new trade or business for purposes of the partial sales and use tax exemption?”

Discussion

Regulation 1525.2(c)(5)(B) provides:

“A qualified person must be engaged in those manufacturing lines of business described in Codes 2000 to 3999, inclusive, of the Standard Industrial Classification Manual published by the United States Office of Management and Budget, 1987 edition [(hereafter “SIC manual”)]. For purposes of this subsection:

“1. For purposes of classifying a line or lines of business, the economic unit shall be the ‘establishment’ and the classification of the line or lines of business will be based on the establishment’s single most predominant activity based upon value of production. The term ‘establishment’ means an economic unit, generally at a single physical location, where business is conducted or where services or manufacturing or other industrial operations are performed. The following will generally constitute an ‘establishment’: a factory, mill store, hotel, movie theater, mine, farm, ranch, bank, railroad depot, airline terminal, sales office, warehouse, or central administrative office.

“2. For purposes of determining the ‘establishment’ or ‘establishments’ of a trade or business:

“a. Where distinct and separate economic activities are performed at a single physical location, such as construction activities operated out of the same physical location as a lumber yard, each activity should be treated as a separate establishment where: (i) no one industry description in the classification includes such combined activities; (ii) the employment in each such economic activity is significant; and (iii) separate reports are prepared on the number of employees, their wages and salaries, sales or receipts, property and equipment, and other types of financial data, such as financial statements, job costing, and profit center accounting. For purposes of this paragraph, whether or not employment in an economic activity is significant shall be based upon all of the facts and circumstances. Nevertheless, employment in an economic activity will be considered to be ‘significant’ for purposes of this paragraph whenever more than 25 percent of the taxpayer’s total number of employees at a single physical location, or more than 25 percent of the taxpayer’s total dollar value of payroll at a single physical location, is attributable to the economic activity being tested for separate establishment status.

“....”

This means that KII will be regarded as engaged in another SIC code operation other than SIC code 5149, “Groceries and Related Products, Not Elsewhere Classified”¹ where no single industry description includes all of KII’s operations, the employment in each of KII’s activities is regarded as significant, and separate reports are prepared on KII’s employees and other types of financial data.

You state that KII employs only one person from its forty-one employees to oversee and coordinate the spice mix production with M---. You also indicated during our May 7, 1996 telephone conversation that KII does not prepare separate financial or employment reports relative to that single employee’s activities and that KII does not manufacture the dehydrated powdered soy sauce that it provides to M---. We further note that the production and packaging agreements that KII maintains with M--- (St---) and S--- (LACP) indicate that M--- and S--- are not the agents or employees of KII. In that regard, you state that KII does not employ anyone nor invest in any capital equipment at the M--- or S--- plants. Under these facts, we conclude that KII is not engaged in any other SIC code operation other than SIC code 5149, and that KII is not engaged in a manufacturing operation inside this state.

Based on the analysis and conclusions from this letter and our previous letter dated April 4, 1996, KFI may qualify for a partial sales and use tax exemption certificate. You should contact Mr. Michael Hilbert ((916) 324-2916) to obtain an application for this certificate or for further assistance in the application process. You should include a copy of this letter and our

¹ We previously concluded in our April 4, 1996 letter that KII’s operations fell within this SIC code based upon the representations set forth in your March 7, 1996 letter to us.

April 4, 1996 letter along with KFI's application for a partial sales and use tax exemption certificate.

If you have any further questions, please write again.

Sincerely,

Warren L. Astleford
Staff Counsel

WLA:rz

cc: Mr. Glenn A. Bystrom - (MIC: 43)
Mr. Dennis Fox - (MIC: 92)
Mr. Michael J. Hilbert - (MIC: 40)
Mr. David H. Levine - (MIC: 82)
--- --- District Administrator (--)