



STATE BOARD OF EQUALIZATION

450 N STREET, SACRAMENTO, CALIFORNIA
PO BOX 942879, SACRAMENTO, CALIFORNIA 94279-0043
1-916-324-1825 • FAX 1-916-322-4530
www.boe.ca.gov

BETTY T. YEE
First District, San Francisco

SEN. GEORGE RUNNER (Ret.)
Second District, Lancaster

MICHELLE STEEL
Third District, Orange County

JEROME E. HORTON
Fourth District, Los Angeles

JOHN CHIANG
State Controller

CYNTHIA BRIDGES
Executive Director

April 11, 2014

Dear Interested Party:

Enclosed are the Agenda, Issue Paper, and Revenue Estimate for the April 22, 2014 Business Taxes Committee meeting. This meeting will address the proposed Regulation 1525.4, *Manufacturing and Research & Development Equipment*.

Please feel free to publish this information on your website or otherwise distribute it to your associates, members, or other persons that may be interested in this issue.

Thank you for your input on these issues and I look forward to seeing you at the Business Taxes Committee meeting at **10:00 a.m.** on **April 22, 2014** in Room 121 at the address shown above.

Sincerely,

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

SB:lw

Enclosures

cc: (all with enclosures)

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

(via email)

Mr. David Hunter, Board Member's Office, Fourth District
Mr. Jaclyn Appleby, Board Member's Office, Fourth District
Mr. Neil Shah, Board Member's Office, Third District
Mr. Tim Treichel, Board Member's Office, Third District

Mr. Alan LoFaso, Board Member's Office, First District
Ms. Mengjun He, Board Member's Office, First District
Ms. Yvette Stowers, Board Member's Office, First District
Mr. Ramon Salazar, Board Member's Office, First District
Mr. Sean Wallentine, Board Member's Office, Second District
Mr. James Kuhl, Board Member's Office, Second District
Mr. Lee Williams, Board Member's Office, Second District
Mr. Alan Giorgi, Board Member's Office, Second District
Ms. Lynne Kinst, Board Member's Office, Second District
Ms. Tanya Vandrick, Board Member's Office, Second District
Ms. Natasha Ralston Ratcliff, State Controller's Office
Ms. Cynthia Bridges (MIC:73)
Mr. Randy Ferris (MIC:83)
Mr. Jeffrey L. McGuire (MIC:43)
Mr. Robert Tucker (MIC:82)
Mr. Bradley Heller (MIC:82)
Mr. Andrew Kwee (MIC: 82)
Mr. Lawrence Mendel (MIC: 82)
Mr. Bradley Miller (MIC:92)
Ms. Kirsten Stark (MIC:50)
Ms. Lynn Whitaker (MIC: 50)
Mr. Michael Patno (MIC: 50)
Ms. Trista Gonzalez (MIC: 44)
Mr. Jason Parker (MIC: 44)
Ms. Tracy McCrite (MIC: 44)
Mr. Robert Prasad (MIC: 44)

AGENDA — April 22, 2014 Business Taxes Committee Meeting
Manufacturing and Research & Development Equipment

<p>Action 1 — Agreed Upon Items Agenda, pages 2-17</p>	<p>Approve and authorize publication of proposed Regulation 1525.4 (except as indicated in Actions 2 - 3) as agreed upon by interested parties and staff.</p>
<p>Action 2 — Definition of Qualified Person - 1525.4 (b)(8)(A) Agenda, page 18</p>	<p>Approve and authorize publication of:</p> <p>Staff’s recommendation which clarifies that a person will not be precluded from the definition of “qualified person” when there is no six digit NAICS code to describe their line of business, provided their business activities are described in a qualified four digit industry group.</p> <p align="center">OR</p> <p>Recommendation from Waste Management which clarifies that a person will not be precluded from the definition of “qualified person” when there is no six digit NAICS code to describe their line of business, provided their activities or products are described in a qualified four digit industry group. This recommendation also includes an example specific to the recycling industry.</p>
<p>Action 3 — Defining “primarily engaged” 1525.4 (b)(8)(A) 1. Paragraph 3 Agenda, page 19</p>	<p>Approve and authorize publication of:</p> <p>Staff’s recommendation which tests “primarily engaged” based on revenues or operating expenses of the entity or establishment. In addition, staff’s recommendation provides that an establishment may qualify if they are primarily engaged based on employee salaries/wages or value of production.</p> <p align="center">OR</p> <p>Recommendation from CalTax which tests “primarily engaged” based on revenues or operating expenses of the entity or establishment. In addition, CalTax’s recommendation provides that an establishment may qualify if they are primarily engaged based on number of employees, employee hours, employee salaries/wages, number of units produced, value of production, or capital investment.</p>

AGENDA — April 22, 2014 Business Taxes Committee Meeting
Manufacturing and Research & Development Equipment

Action Item	Proposed Regulation 1525.4 as agreed upon by interested parties and staff
--------------------	--

Action 1 — Agreed Upon Items	<p>Regulation 1525.4, <i>Manufacturing and Research & Development Equipment</i></p> <p>(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.</p> <p>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 percent). 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.</p> <p>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 percent). 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.</p> <p>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:</p> <p>(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.</p> <p>(2) Qualified tangible personal property purchased for use by a qualified person to be used primarily in research and development.</p>
-------------------------------------	--

AGENDA — April 22, 2014 Business Taxes Committee Meeting
Manufacturing and Research & Development Equipment

Action Item	Proposed Regulation 1525.4 as agreed upon by interested parties and staff
--------------------	--

	<p>(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).</p> <p>(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.</p> <p>(b) DEFINITIONS. For the purposes of this regulation:</p> <p>(1) “Fabricating” means to make, build, create, produce, or assemble components or tangible personal property to work in a new or different manner.</p> <p>(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.</p> <p>(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.</p> <p>(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.</p>
--	---

AGENDA — April 22, 2014 Business Taxes Committee Meeting
Manufacturing and Research & Development Equipment

Action Item	Proposed Regulation 1525.4 as agreed upon by interested parties and staff
--------------------	--

	<p>(5) “Primarily” means 50 percent or more of the time.</p> <p>(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.</p> <p>(7) “Processing” means the physical application of the materials and labor necessary to modify or change the characteristics of tangible personal property.</p> <p>(8) (A) “Qualified person” [See Action 2, page 18]</p> <p>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.</p> <p>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.</p> <p>[See Action 3, page 19]</p> <p>For purposes of this test, the gross revenues may be derived from a combination of qualified manufacturing lines of business</p>
--	---

AGENDA — April 22, 2014 Business Taxes Committee Meeting
Manufacturing and Research & Development Equipment

Action Item	Proposed Regulation 1525.4 as agreed upon by interested parties and staff
--------------------	--

	<p>and from qualified research and development lines of business. For example, if a company derives 40 percent of its gross receipts from qualified manufacturing activities and 40 percent from non-qualified manufacturing activities; but the remaining 20 percent of its gross receipts are derived from qualified research and development contracts, the company would qualify because overall, 60 percent of the gross receipts are from qualifying activities.</p> <p>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.</p> <p>There may be more than one qualifying establishment within a legal entity.</p> <p>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.</p> <p>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.</p> <p>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.</p> <p>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 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</p>
--	--

AGENDA — April 22, 2014 Business Taxes Committee Meeting
Manufacturing and Research & Development Equipment

Action Item	Proposed Regulation 1525.4 as agreed upon by interested parties and staff
--------------------	--

	<p>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.</p> <p align="center">(B) Notwithstanding subdivision (b)(8)(A), “qualified person” does not include:</p> <ol style="list-style-type: none"> 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. <p>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.</p> <p align="center">(9) (A) “Qualified tangible personal property” includes, but is not limited to, all of the following:</p> <ol style="list-style-type: none"> 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, <i>Manufacturing Aids</i>, 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,
--	--

AGENDA — April 22, 2014 Business Taxes Committee Meeting
Manufacturing and Research & Development Equipment

Action Item	Proposed Regulation 1525.4 as agreed upon by interested parties and staff
--------------------	--

	<p>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:</p> <p>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).</p> <p>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.</p> <p>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.</p> <p>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.</p> <p>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.</p> <p>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</p>
--	---

AGENDA — April 22, 2014 Business Taxes Committee Meeting
Manufacturing and Research & Development Equipment

Action Item	Proposed Regulation 1525.4 as agreed upon by interested parties and staff
--------------------	--

	<p>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.</p> <p>(B) “Qualified tangible personal property” does not include any of the following:</p> <ol style="list-style-type: none"> 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. <p>(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.</p> <p>(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.</p> <p>(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.</p> <p>(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</p>
--	--

AGENDA — April 22, 2014 Business Taxes Committee Meeting
Manufacturing and Research & Development Equipment

Action Item	Proposed Regulation 1525.4 as agreed upon by interested parties and staff
--------------------	--

	<p>income or franchise tax purposes shall be deemed to have a useful life of less than one year for purposes of this regulation.</p> <p>(c) PARTIAL EXEMPTION CERTIFICATE.</p> <p>(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.</p> <p>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.</p> <p>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).</p> <p>The exemption certificate form set forth in Appendix A may be used as an exemption certificate.</p> <p>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)</p>
--	---

AGENDA — April 22, 2014 Business Taxes Committee Meeting
Manufacturing and Research & Development Equipment

Action Item	Proposed Regulation 1525.4 as agreed upon by interested parties and staff
--------------------	--

	<p>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.</p> <p>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.</p> <p>(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 the 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.</p> <p>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.</p> <p>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.</p> <p>(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:</p> <ul style="list-style-type: none"> (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
--	--

AGENDA — April 22, 2014 Business Taxes Committee Meeting
Manufacturing and Research & Development Equipment

Action Item	Proposed Regulation 1525.4 as agreed upon by interested parties and staff
--------------------	--

	<p>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.</p> <p>(D) A statement that the property purchased is:</p> <ol style="list-style-type: none"> 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). <p>(E) A statement that the purchaser is:</p> <ol style="list-style-type: none"> 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). <p>(F) A statement that the property purchased is qualified tangible personal property as described in subdivision (b)(9)(A).</p> <p>(G) A description of property purchased.</p> <p>(H) The date of execution of the document.</p> <p>(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.</p> <p>(5) GOOD FAITH. A seller will be presumed to have taken a partial exemption certificate in good faith in the absence of</p>
--	--

AGENDA — April 22, 2014 Business Taxes Committee Meeting
Manufacturing and Research & Development Equipment

Action Item	Proposed Regulation 1525.4 as agreed upon by interested parties and staff
--------------------	--

	<p>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).</p> <p>(d) WHEN THE PARTIAL EXEMPTION DOES NOT APPLY. The exemption provided by this regulation shall not apply to either of the following:</p> <p>(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.</p> <p>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.</p> <p>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.</p> <p>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.</p> <p>(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.</p> <p>(e) PURCHASER’S LIABILITY FOR THE PAYMENT OF SALES TAX. If a purchaser certifies in writing to the seller</p>
--	---

AGENDA — April 22, 2014 Business Taxes Committee Meeting
Manufacturing and Research & Development Equipment

Action Item	Proposed Regulation 1525.4 as agreed upon by interested parties and staff
--------------------	--

	<p>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.</p> <p>(f) LEASES. Leases of qualified tangible personal property classified as “continuing sales” and “continuing purchases” in accordance with Regulation 1660, <i>Leases of Tangible Personal Property – In General</i>, 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.</p> <p>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.</p> <p>(g) CONSTRUCTION CONTRACTORS. The application of sales and use tax to construction contracts is explained in Regulation 1521, <i>Construction Contractors</i>. 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.</p> <p>(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</p>
--	---

AGENDA — April 22, 2014 Business Taxes Committee Meeting
Manufacturing and Research & Development Equipment

Action Item	Proposed Regulation 1525.4 as agreed upon by interested parties and staff
--------------------	--

	<p>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).</p> <p>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).</p> <p>(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.</p> <p>(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.</p> <p>(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.</p>
--	---

AGENDA — April 22, 2014 Business Taxes Committee Meeting
Manufacturing and Research & Development Equipment

Action Item	Proposed Regulation 1525.4 as agreed upon by interested parties and staff
--------------------	--

	<p align="center">Appendix A</p> <p align="center">PARTIAL EXEMPTION CERTIFICATE FOR MANUFACTURING AND RESEARCH & DEVELOPMENT EQUIPMENT – SECTION 6377.1</p> <p>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.</p> <p>I hereby certify that the tangible personal property described below and purchased or leased from:</p> <p>_____ SELLER'S/LESSOR'S NAME</p> <p>_____ SELLER'S/LESSOR'S ADDRESS (Street, City, State, Zip Code)</p> <p>_____</p> <p>is qualified tangible personal property and will be used by me primarily (please check one):</p> <p><input type="checkbox"/> 1. for manufacturing, processing, refining, fabricating, or recycling;</p> <p><input type="checkbox"/> 2. for research and development;</p> <p><input type="checkbox"/> 3. to maintain, repair, measure, or test any property being used for (1) or (2) above; or</p> <p><input type="checkbox"/> 4. as a special purpose building and/or foundation.</p> <p>Description of qualified tangible personal property purchased or leased¹:</p> <p>_____</p> <p>_____</p> <p>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.</p> <p>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.</p>
--	--

AGENDA — April 22, 2014 Business Taxes Committee Meeting
Manufacturing and Research & Development Equipment

Action Item	Proposed Regulation 1525.4 as agreed upon by interested parties and staff
--------------------	--

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;
- the property is converted for use in a manner not qualifying for the exemption; **or**
- the property 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

AGENDA — April 22, 2014 Business Taxes Committee Meeting
Manufacturing and Research & Development Equipment

Action Item	Proposed Regulation 1525.4 as agreed upon by interested parties and staff
--------------------	--

	<p>facility for use in connection with those processes.</p> <p>Description of qualified tangible property purchased¹:</p> <p>_____</p> <p>_____</p> <p>_____</p> <p>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.</p> <p>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.</p> <p>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.</p> <table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%; border-bottom: 1px solid black;">NAME OF PURCHASER</td> <td style="width: 50%; border-bottom: 1px solid black;">SIGNATURE OF PURCHASER, PURCHASER'S EMPLOYEE, OR AUTHORIZED REPRESENTATIVE</td> </tr> <tr> <td style="border-bottom: 1px solid black;">PRINTED NAME OF PERSON SIGNING</td> <td style="border-bottom: 1px solid black;">TITLE</td> </tr> <tr> <td colspan="2" style="border-bottom: 1px solid black;">ADDRESS OF PURCHASER</td> </tr> <tr> <td style="border-bottom: 1px solid black;">PERMIT NUMBER (IF YOU ARE NOT REQUIRED TO HOLD A PERMIT, EXPLAIN WHY)</td> <td style="border-bottom: 1px solid black;">TELEPHONE NUMBER</td> </tr> <tr> <td style="border-bottom: 1px solid black;">EMAIL ADDRESS OF PERSON SIGNING</td> <td style="border-bottom: 1px solid black;">DATE</td> </tr> </table> <p>_____</p> <p>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.</p>	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
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										

AGENDA — April 22, 2014 Business Taxes Committee Meeting
Manufacturing and Research & Development Equipment

Action Item	Alternative 1 - Staff Recommendation	Alternative 2 – Regulatory Language Proposed by Waste Management	Alternative 3 – Regulatory Language Proposed by CalTax
<p>Action 2 — Definition of Qualified Person 1525.4 (b)(8)(A)</p>	<p>(b) (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 described in a qualified four digit industry group. For the purpose of this subdivision:</p>	<p>(b) (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. 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.</p> <p>For the purpose of this subdivision:</p>	<p>[No alternative language provided for this section.]</p>

AGENDA — April 22, 2014 Business Taxes Committee Meeting
Manufacturing and Research & Development Equipment

Action Item	Alternative 1 - Staff Recommendation	Alternative 2 – Regulatory Language Proposed by Waste Management	Alternative 3 – Regulatory Language Proposed by CalTax
<p>Action 3 — Defining “primarily engaged” 1525.4 (b)(8)(A) 1.</p>	<p>(b)(8)(A) 1. <i>[beginning paragraph 3]</i></p> <p>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 either of the following to/from a qualifying line of business: (1) Employee salaries and wages, or (2) Value of production.</p>	<p>[No alternative language provided for this section.]</p>	<p>(b)(8)(A) 1. <i>[beginning paragraph 3]</i></p> <p>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 of the following to a qualifying line of business, as measured by:</p> <ol style="list-style-type: none"> (1) Number of employees; (2) Employee hours; (3) Employee salaries and wages; (4) Number of units produced; (5) Value of production; or (6) Capital investment. <p>For example, an establishment is a qualified person primarily engaged in a qualifying line of business if the number of employees allocated to research and development constitute 50 percent or more of the employees at that establishment.</p>

Issue Paper Number 14-001



BOARD OF EQUALIZATION
KEY AGENCY ISSUE

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

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

I. Issue

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

II. Alternative 1 – Staff Recommendation

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

III. Other Alternatives Considered

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

Alternative 2 – Waste Management Recommendation

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

Alternative 3 – CalTax Recommendation

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

IV. Background

General

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

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

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

Prior partial exemption for manufacturing equipment

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

V. Discussion

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

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

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

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

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

Definition of Qualified Person - Qualifying NAICS Codes

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

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

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

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

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

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

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

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

Definition of Qualified Person – Primarily Engaged

RTC section 6377.1 (b)(6)(A) provides that “qualified person” means a person that is primarily engaged in those lines of business described in Codes 3111 to 3399, inclusive, 541711, or 541712 of the NAICS. The definition of a qualified person is further interpreted and clarified in proposed Regulation 1525.4 (b)(8)(A).

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

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

FORMAL ISSUE PAPER 14-001

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

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

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

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

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

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

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

FORMAL ISSUE PAPER 14-001

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:

FORMAL ISSUE PAPER 14-001

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

D. Statutory or Regulatory Changes for Alternative 2

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

E. Operational Impact of Alternative 2

Same as Alternative 1.

F. Administrative Impact of Alternative 2

1. Cost Impact

Same as Alternative 1.

2. Revenue Impact

None. See Revenue Estimate (Exhibit 1).

G. Taxpayer/Customer Impact of Alternative 2

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

H. Critical Time Frames for Alternative 2

Same as Alternative 1.

VIII. Alternative 3

A. Description of Alternative 3

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

B. Pros of Alternative 3

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

C. Cons of Alternative 3

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

D. Statutory or Regulatory Changes for Alternative 3

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

E. Operational Impact of Alternative 3

Same as Alternative 1.

F. Administrative Impact of Alternative 3

1. Cost Impact

Same as Alternative 1.

2. Revenue Impact

None. See Revenue Estimate (Exhibit 1).

G. Taxpayer/Customer Impact of Alternative 3

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

H. Critical Time Frames for Alternative 3

Same as Alternative 1.

Preparer/Reviewer Information

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

Current as of: April 2, 2014

REVENUE ESTIMATE

STATE OF CALIFORNIA
BOARD OF EQUALIZATION



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. 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 Alternative(s) 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. 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.

FORMAL ISSUE PAPER 14-001**Alternative 3 – CalTax Recommendation**

CalTax recommends that with respect an establishment, the test for determining whether a qualified person is “primarily engaged” should include more alternatives than the staff recommendation.

Background, Methodology, and Assumptions**Alternative 1 – Staff Recommendation**

There is nothing in staff recommendation that would impact revenue. 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. Staff recommendation implements legislation declaratory of existing law. Therefore, this proposed Regulation 1524.5 does not have a revenue impact.

Other Alternatives Considered

Alternative 2 – There is nothing in alternative 2 that would impact revenue because an establishment must meet the definition for a qualified person defined as follows: 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).

Alternative 3 – There is nothing in alternative 3 that would impact revenue because an establishment must meet the definition for a qualified person defined as follows: 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).

Revenue Summary

Alternative 1 – staff recommendation does not have a revenue impact.

Alternative 2 and Alternative 3 do not have a revenue impact.

Preparation

Mr. Bill Benson, Jr., Research and Statistics Section, Legislative and Research Division, prepared this revenue estimate. This estimate has been reviewed by Mr. Joe Fitz, Chief, Research and Statistics Section, Legislative and Research Division, and Ms. Susanne Buehler, Chief, Tax Policy Division, Sales and Use Tax Department. For additional information, please contact Mr. Benson at (916) 445-0840.

Current as of April 2, 2014.

Regulation 1525.4, *Manufacturing and Research & Development Equipment*

Reference: Section 6377.1, Revenue and Taxation Code

(a) PARTIAL EXEMPTION FOR PROPERTY PURCHASED FOR USE IN MANUFACTURING AND RESEARCH AND DEVELOPMENT. Except as provided in subdivision (d), beginning July 1, 2014, and before July 1, 2022, section 6377.1 of the Revenue and Taxation Code (RTC) provides a partial exemption from sales and use tax for certain sales and purchases, 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 percent). 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 percent). 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 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 either of the following to/from a qualifying line of business: (1) employee salaries and wages, or (2) value of production.

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 percent of its gross receipts from qualified manufacturing activities and 40 percent from non-qualified manufacturing activities; but the remaining 20 percent of its gross receipts are derived from qualified research and development contracts, the company would qualify because overall, 60 percent of the gross receipts 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 that person shall be considered to be a “qualified person” for purposes of this regulation only as to those purchases that are intended to be used and are actually used in an establishment in which the purchaser is primarily engaged in those lines of business described in Codes 3111 to 3399, inclusive, 541711, or 541712.

(B) Notwithstanding subdivision (b)(8)(A), “qualified person” does not include:

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

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

In general, these apportioning trades or businesses derive more than 50 percent of their gross business receipts from an agricultural business activity, an extractive business activity, a savings and loan activity, or a banking or financial business activity as defined in subdivision (d) of RTC section 25128.

(9) (A) “Qualified tangible personal property” includes, but is not limited to, all of the following:

1. Machinery and equipment, including component parts and contrivances such as belts, shafts, moving parts, and operating structures. For purposes of this subdivision, manufacturing aids as described in Regulation 1525.1, *Manufacturing Aids*, may be considered machinery and equipment, when purchased by a qualified person for use by that person in a manner qualifying for exemption, even though such property may subsequently be delivered to or held as property of the person to whom the manufactured product is sold. The manufacturing aids must meet the useful life requirement of subdivision (b)(13).

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

and regardless of whether the machine or component parts are assembled by the qualified person or another party.

3. Tangible personal property used in pollution control that meets or exceeds standards established by this state or any local or regional governmental agency within this state at the time the qualified tangible personal property is purchased.

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

a. "Special purpose building and foundation" means only a building and the foundation underlying the building that is specifically designed and constructed or reconstructed for the installation, operation, and use of specific machinery and equipment with a special purpose and the construction or reconstruction of which is specifically designed and used exclusively for the specified purposes as set forth in subdivision (a) (the qualified purpose). Special purpose buildings and foundations also include foundations for open air structures that may not have ceilings or enclosed walls but are used exclusively for the specified purposes as set forth in subdivision (a).

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

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

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

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

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

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

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

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

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

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

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

(c) PARTIAL EXEMPTION CERTIFICATE.

(1) IN GENERAL. Qualified persons who purchase or lease qualified tangible personal property from an in-state retailer, or an out-of-state retailer obligated to collect use tax, must provide the retailer with a partial exemption certificate in order for the retailer to claim the partial exemption. If the retailer takes a timely partial exemption certificate in the proper form as set forth in subdivision (c)(3) and in good faith as defined in subdivision (c)(4), from a qualified person, the partial exemption certificate relieves the retailer from the liability for the sales tax subject to exemption under this regulation or the duty of collecting the use tax subject to exemption under this regulation. A certificate will be considered timely if it is taken any time before the seller bills the purchaser for the property, any time within the seller’s normal billing or payment cycle, or any time at or prior to delivery of the property to the purchaser.

On occasion a potential qualified person may not know at the time of purchase whether they will meet the requirements for the purpose of claiming the partial exemption until the expiration of the one year period following the date of purchase as provided in subdivision (b)(8)(A). The purchaser may issue a partial exemption certificate at the time of the purchase based on the expectation that the purchaser will meet the requirements of the regulation. If those requirements are not met, the purchaser will be liable for payment of sales tax, with applicable interest as if the purchaser were a retailer making a retail sale of the tangible personal property at the time the tangible personal property is purchased.

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

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

Contractors purchasing property for use in the performance of a construction contract for a qualified person as described in subdivision (a)(4), who purchase qualified tangible personal property from an in-state retailer, or an out-of-state retailer obligated to collect use tax, must provide the retailer with a partial exemption certificate in order for the retailer to claim the partial exemption. If the retailer takes a timely partial exemption certificate in the proper form as set forth in subdivision (c)(3) and in good faith as defined in subdivision (c)(5), from the contractor, the partial exemption certificate relieves the retailer from the liability for the sales tax subject to exemption under this regulation or the duty of collecting the use tax subject to exemption under this regulation.

The exemption certificate form set forth in Appendix B may be used by construction contractors as an exemption certificate when they are purchasing qualified tangible personal property for use in a construction contract for a qualified person.

(2) **BLANKET PARTIAL EXEMPTION CERTIFICATE.** In lieu of requiring a partial exemption certificate for each transaction, a qualified person may issue a blanket partial exemption certificate. The partial exemption certificate forms set forth in Appendix A and Appendix B may be used as blanket partial exemption certificates. In the 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 (b)(9)(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.

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 personal property purchased or leased¹:

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;
- the property is converted for use in a manner not qualifying for the exemption; **or**
- the property is 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 personal property purchased¹:

--

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.

From: [Buehler, Susanne](#)
To: [Whitaker, Lynn](#); [Oakes, Clifford](#); [Stark, Kirsten](#)
Subject: FW: CalTax Comments to Proposed Reg 1525.4 -- Third Discussion Paper
Date: Friday, February 28, 2014 3:01:18 PM
Attachments: [Comments to BOE Manuf SUT Exemption - Third Discussion 2-28.docx](#)

From: Therese Twomey [mailto:Therese@caltax.org]
Sent: Friday, February 28, 2014 2:01 PM
To: Buehler, Susanne
Subject: CalTax Comments to Proposed Reg 1525.4 -- Third Discussion Paper

Susanne,

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

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



As of February 28, 2014

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

General Observations:

1. The California Taxpayers Association wishes to acknowledge the efforts of the Board of Equalization (BOE) staff, and to express our appreciation for their work in providing guidance to taxpayers on this very important issue. Over the past several months, the regulatory language has been significantly improved with clarifying definitions and terminology pertaining to qualifying equipment, qualifying manufacturing processes, the exemption certificate, and others.

At the first interested parties meeting, stakeholders and BOE staff agreed that we should look to prior statutes, regulations, and case law in developing regulation 1525.4. Many of the concepts and definitions included in this regulation were borrowed from prior reference. While some are applicable for purposes of this regulation, other definitions and the omission of certain concepts will have the inadvertent effect of preventing the majority of manufacturers and research-and-development companies from qualifying for the sales/use tax exemption. We have discussed our concerns with BOE staff, and are providing specific recommendations to remedy this, as well as to clarify other portions of the proposed regulation, as discussed below.

Specific Comments:

1. In our last discussion and submittal, we urged that the regulations identify two approaches for determining whether a taxpayer is a qualified person. Specifically, we recommended that "primarily engaged" be determined at either the entity level or at the establishment level. As currently drafted, the proposed regulation speaks to only the "establishment", thus inadvertently disqualifying or limiting many manufacturers and R&D entities. To remedy this, we recommend that the

following language be added after the definition of “qualified person” referenced in subdivision (b)(8)(A) of the regulations:

“For purposes of this subdivision, a person may be “primarily engaged” either as a legal entity or as an establishment within a legal entity.

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, or 541711 or 541712 of the NAICS Codes. 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.

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 a qualifying line of business, as measured by:

- (1) Number of employees;
- (2) Employee hours;
- (3) Employee salaries and wages;
- (4) Number of units produced;
- (5) Value of production;
- (6) Capital investment; or
- (7) Other reasonable measurement that is representative of an establishment’s level of activity in a qualifying line of business.

For example, an establishment is a qualified person primarily engaged in a qualifying line of business if the number of employees allocated to research and development constitute 50 percent or more of the employees at that establishment.

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

Since these provisions address the “primarily engaged” definitions, we suggest deletion of the following language contained in the draft regulation as it is no longer needed.

~~1. “Primarily engaged” means 50 percent or more of gross revenues, including intercompany and intra-company charges, are derived from the qualifying manufacturing or research and development activities described in~~

~~subdivisions (a)(1) and (a)(3) for the financial year of the purchaser preceding the purchase of the property. In the case of a nonprofit organization, “primarily engaged” means 50 percent or more of the funds allocated to the establishment are attributable to such qualifying manufacturing activities.~~

~~For purposes of determining if a purchaser is “primarily engaged” in research and development activities described in NAICS 541711 or 541712, “primarily engaged” means 50 percent or more of the expenses of the establishment are for such qualifying research and development activities as described in subdivisions (a)(2) and (a)(3) for the financial year of the purchaser preceding the purchase of the property.~~

2. The proposed regulations define “establishment” to mean a single physical location where an economic activity is conducted, and further limits “establishment” to a building or interconnected structure. This definition would be limiting for manufacturers and companies engaged in R&D who conduct qualifying activities in different buildings located in a campus setting, or who conduct qualifying activities in multiple locations. To remedy this, we recommend that subdivision (b)(8)(A)(2) be deleted in its entirety, and redrafted as follows.

“For purposes of this subdivision, “establishment” means either an economic unit or a cost center for which separate reports are prepared for either costs, number of employees, wages or salaries, property and equipment, job costing, profit or loss, or any other type of financial data pertaining to manufacturing or research-and-development activities.

Qualifying activities conducted at different physical locations or in different buildings that are part of the same economic unit or cost center may be considered part of the same “establishment”. For example, research and development activities in two different locations but that are part of the same economic unit or cost center would be considered an “establishment”.”

We also suggest definitions to clarify “legal entity”.

“For purposes of this subdivision, “legal entity” includes, but is not limited to, a c-corporation, s-corporation, limited liability company, partnership, joint venture, co-op, or sole proprietorship.”

3. The proposed regulations authorize establishments primarily engaged in manufacturing to be eligible for the sales/use tax exemption on purchases of research-and-development equipment, and vice-versa. We recommend clarifying language to apply the same authorization to entities, as follows:

“An entity primarily engaged in manufacturing activities may purchase qualified tangible personal property that is 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 primarily engaged in

research and development may purchase tangible personal property that is 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.”

We also suggest clarification to the existing first paragraph of (b)(8)(3) pertaining to establishments as follows. Please note suggested additions are shown in bold italics, and suggested deletions are shown as strike-out.

“An establishment primarily engaged in manufacturing activities may purchase qualified tangible personal property ***that is subject to the partial sales and use tax exemption*** for use in research and development ~~subject to the partial exemption, and vice versa,~~ provided all other requirements for ***the exemption*** are met. ***An establishment primarily engaged in research and development may purchase qualified tangible personal property that is subject to the partial sales and use tax exemption for use in manufacturing, provided all other requirements for the exemption are met.***”

4. The proposed regulation outlines procedures for filing a claim for refund. While a claim for refund may be workable for some businesses, it may represent substantial administrative burdens on other businesses – not to mention the potentially significant workload that would be imposed on the BOE to process these claims. To mitigate staffing costs to the BOE and to facilitate administration, we recommend that businesses be allowed to offset refunds on their sales and use tax returns by adding the following language as a new subdivision (i) :

“OFFSETTING CLAIM ON SALES AND USE TAX RETURN. Qualified purchasers who paid tax or tax reimbursement to the seller or the Board may use any qualifying manufacturing or research-and-development partial exemption to offset sales and use tax liability on their sales and use tax return if and only if the purchase was a use tax transaction. In order to be timely, the offsetting claim must be filed with the Board or taken within the period specified in section 6902 of the RTC.

The taxpayer filing the return is responsible for verifying they are a qualified purchaser and maintaining adequate books and records to substantiate all manufacturing and/or research-and-development partial exemption offsets claimed.”

5. Subdivision (h) of the proposed regulations appear to imply that a taxpayer claiming a refund must also issue a partial exemption certificate to the reseller.

While this should clearly be an option for the purchaser, it should not be mandated. Such a requirement would be problematic for taxpayers who may choose to forgo the exemption certificate process, and pay the full sales and use tax to the seller in order to better monitor compliance with the \$200 million cap. Therefore, we suggest deletion as follows:

(h) CLAIM FOR REFUND. Qualified purchasers who paid tax or tax reimbursement to the seller or the Board ~~and who thereafter issue a partial exemption certificate to the seller,~~ 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. 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.

6. The proposed regulation stipulates that a contractor is also a qualified person if the contractor manufactures tangible personal property for retail sale. Some contractors process or refine tangible personal property, rather than manufacture property. Since processing, refining, fabricating and recycling are all qualifying uses of the equipment, we suggest deleting the reference to manufacturing and making a general reference.

Also, in our last submittal we suggested the addition of language to clarify that contractors who are also qualified persons would be availed of a \$200 million cap that is separate from that availed to a consumer. The regulations clarify the application of the cap with regard to materials and fixtures sold or used in a construction of a special purpose building or foundation as it relates to the consumer, but do not address the application of the cap to contractors who are also qualified persons. We reiterate the need for clarifying language as it pertains to contractors who are also qualified persons.

To address both of these concerns, we recommend the third paragraph in (g) related to construction contractors be redrafted such that the sentence beginning with "However" reads as follows. Additions are shown in bold italics, and deletions are shown as strike-out.

"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 because, for example, if the contractor manufactures tangible personal property for retail sale may purchase property subject to the partial exemption if all other requirements for the exemption are met.~~ ***If the contractor meets all the other requirements of a qualified person, including either the manufacturing, processing, refining, fabricating or recycling provisions under subdivision (a)(1), then the \$200,000,000 million limit is applied to the qualified person's***

equipment purchases. This limit is separate and apart from the limit that is applied to materials and fixtures that are part of a contracted construction project for qualified taxpayers.

7. The proposed regulations seek to define “special purpose building and foundation”. Some of the definitions are unnecessarily confusing or duplicative of statutes, and we recommend they be deleted as follows. Deletions are shown as strike-out.

“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) of this regulation (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).

We also recommend the deletion of (b)(9)(A)(b) and (b)(9)(A)(c) as they are unnecessary and inferred in (b)(9)(A)(e).

8. The proposed regulations require that the blanket partial exemption certificate include a contemporaneous document that provides a description of the property being purchased. This requirement runs counter to the purpose of a blanket exemption, which is to provide a general-purpose exemption for multiple equipment without individually itemizing the various equipment. We recommend deletion of the last sentence of the second paragraph under (2) BLANKET PARTIAL EXEMPTION CERTIFICATE, which reads “Such documents referencing the blanket partial exemption certificate must include a description of the property being purchased.”
9. Appendix A and Appendix B, pertaining to the exemption certificate, appear to require that a blanket certificate be referenced on all purchase orders or other designated documents. Such a requirement is unnecessary and confusing, especially if the taxpayer chooses not to issue a blanket certificate. We recommend deletion of language from Appendix A and Appendix B as follows:

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. ~~You must~~

~~reference this blanket certificate on future purchase orders or on other designation as provided in Regulation 1525.4 (c)(2).~~

10. The proposed regulation requires qualified persons to issue an exemption certificate to a contractor, and requires contractors to issue a different exemption certificate to retailers. The regulations do not specify the liable party in an instance where an exempt purchase is later determined to be disqualified. We suggest that the regulations provide guidance on this issue.
11. Subdivision (a)(4) of the proposed regulation provides that tangible property purchased for use by a contractor would qualify for the exemption if it is used to improve “real” property. Some construction projects involve improvements to major fixtures, which are considered personal property and not “real” property. As currently drafted, contractor purchases made to improve fixtures or major tooling equipment would be disqualified. To remedy this, we recommend deletion of “real”.
12. The proposed regulations authorize exemption for qualifying pollution control equipment and define “pollution control” to mean pollution abatement activities that meet or exceed the government standards that are in place at the time the qualified equipment is purchased. This provision provides a safe harbor for equipment purchases to the extent pollution reduction requirements change between the time the equipment is purchased and when it is placed into operation. We suggest that this safe harbor be extended to leased equipment, and the language specify that such equipment qualifies if it meets the pollution control standards that are in place at the time the lease is initiated.
13. In (c)(1), the proposed regulations erroneously cross-reference (c)(4) as the section pertaining to good faith acceptance of an exemption certificate. The reference (c)(4) should be change to (c)(5) in the first and fifth paragraphs of subdivision (c)(1).
14. In (c)(3)(E) pertaining to the exemption certificate, we recommend language clarifying that a purchaser may be either a qualified person primarily engaged in qualifying activities or a contractor for a qualified person, but is not required to be both.



WASTE MANAGEMENT

Public Affairs
915 L Street, Suite 1430
Sacramento, CA 95814
916/552-5859
916/448-2470Fax

March 4, 2014

Ms. Susanne Buehler, Chief
Tax Policy Division (MIC:92)
Board of Equalization
450 N Street
P.O. Box 942879
Sacramento, CA 94279-0092

Via Email: Susanne.Buehler@boe.ca.gov

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

Dear Ms. Buehler:

Waste Management (WM) appreciates the Board of Equalization (BOE) staff efforts in soliciting input and providing guidance to taxpayers on this very important issue. As highlighted at the third interested parties meeting, the issues around determining if a taxpayer qualifies for the exemption have not been fully resolved. Our comments revolve around two main concerns:

- 1) whether the determination may be made at the entity-level, the establishment-level, or both, as expressed at the meeting; and
- 2) the application of the North American Industry Classification System (NAICS) codes to recycling.

To this point, we respectfully suggest that clarification with respect to recycling may be warranted since recycling is clearly contemplated within the statute, yet does not fall neatly into a single NAICS code. *See* Cal. Rev. and Tax. Code § 6377.1(a)(1).

Also, your sister state Department, CalRecycle, is heavily engaged in developing incentives to support investment in recycling infrastructure. I have cc'd CalRecycle's Director, Caroll Mortensen and her key Deputy Directors on this letter.

We appreciate the opportunity to provide our perspective on these issues, as further discussed below.

Specific Comments:

- 1) **The term “establishment” should include a bright-line test for qualifying manufacturing activities that maintain separate books & records.**

In reviewing this third draft of the proposed regulation, we agree with the general consensus that “primarily engaged” may be determined at either the entity-level or at the establishment-level, based on the existence of separate books and records for the economic unit or activity.

The proposed regulation defines “establishment” to mean a single physical location where an economic activity is conducted and further limits “establishment” to a building or interconnected structure. We believe this is too restrictive and does not allow for a single location performing multiple economic activities or for multiple locations performing the same qualifying activities.

This may be remedied by deleting subdivision (b)(8)(A)(2) as currently proposed by BOE, and redrafting it to read as follows:

“For purposes of this subdivision, “establishment” may include either a single or multiple physical locations where a qualified economic activity is performed, and which has 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 economic activity.

A physical location may be described in more than NAICS code.

- 2) **The 4 digit NAICS code for “Recycling” should be the code of the raw material being processed.**

Pursuant to Section 6377.1(b)(6)(A), a qualified person must be primarily engaged in a line of business described in codes 3111 to 3399, inclusive, or 541711 or 541712.

The statute clearly invokes the 4 digit NAICS codes for manufacturing; yet for R&D the full 6 digit codes are specified. Thus, the legislature distinguished between 4 and 6 digit codes.

“NAICS is a 2- through 6-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.¹”

¹ <http://www.census.gov/eos/www/naics/faqs/faqs.html#q5>

The fifth and sixth digits are country-specific and not relevant for purposes of 6377.1(b)(6)(A), even though a complete and valid NAICS code contains six digits.

Recycling does not have a unique 4 digit NAICS industry group. Rather, recycling generally falls under the 4 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 and then is sorted, crushed, sized cleaned, and processed into an intermediate product that is then sold to other manufacturers for further processing. This activity would fall under the industry group 3272, Glass and Glass Product Manufacturing.
- Plastic, Metals and Paper are first sorted, then may be sized, crushed or shredded and then baled or otherwise packaged or containerized for shipment. The baled, packaged or containerized product is sold to a customer for further processing. These activities should fall in the NAICS code of the material being processed and sold. 3261 for plastics, 331X based on the type of metal and 3222 for paper products.

We believe that language should be incorporated into the proposed regulation to clarify the proper use of the NAICS codes for a qualified taxpayer performing recycling activities. Such language should permit recyclers to invoke the applicable 4 digit industry group of the material being processed for sale.

This may be accomplished either by a special provision for the recycling industry, or be revising subdivision (b)(8)(A) to read as follows:

“ ‘Qualified person’ means a person that is primarily engaged in those lines of business described in the manufacturing sector Codes 3111 to 3399, inclusive, research and development sector codes 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 4 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 4 digit industry group.”

This provision would clearly allow investments in recycling infrastructure to be eligible for the partial sales and use tax credit envisioned by BOE proposed Rule 1525.4, regardless of where that recycling infrastructure is located. This will allow WM and others in the solid waste and

recycling industry to take advantage of the partial sales and use tax exemption for equipment and property used in California for purposes of “Recycling” in accordance with the definition currently proposed in Rule 1525.4.

Thank you for the opportunity to provide these comments for your consideration. WM is hopeful that you will agree that the interpretations we are suggesting will promote recycling in California and are consistent with both the letter and intent of SB 90 and other policies and programs of the State of California.

Very truly yours,

Charles A. White, P.E.
Director of Regulatory Affairs/West

cc: Carol Mortensen, Director, CalRecycle, caroll.mortensen@calrecycle.ca.gov
Scott Smithline, Deputy Director, CalRecycle, scott.smithline@calrecycle.ca.gov
Howard Levenson, Deputy Director, CalRecycle, howard.levenson@calrecycle.ca.gov
Lynn Whitaker, BOE, lynn.whitaker@boe.ca.gov



QUALCOMM Incorporated

5775 Morehouse Drive
San Diego, CA 92121-1714

www.qualcomm.com

February 28, 2014

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

by Email: Susanne.Buehler@boe.ca.gov

Re: Comment for Proposed Regulation §1525.4 – Third Discussion Paper

Dear Ms. Buehler,

I would like to thank you and your team for taking the time and effort to collaborate with taxpayers on regulatory drafts. Thoughtfully constructed regulations save countless hours during the compliance and audit processes. During the Third Interested Parties meeting on February 18, 2014 staff requested written recommendations outlining industry input. I am writing with my comments and suggestions for Proposed Regulation §1525.4.

Qualified Person – “Primarily Engaged”

To keep the exemption as inclusive as allowable, we recommend that the test to determine whether a taxpayer is “Primarily Engaged” is 50% or more of all activities in the qualifying NAICS codes and have tests based on Gross Revenues or Expenses.

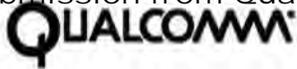
Test Based on Gross Receipts

As drafted:

1. “Primarily engaged” means 50 percent or more of gross revenues, including intercompany and intra-company charges, are derived from the qualifying manufacturing or research and development activities described in subdivisions (a)(1) – and (a)(3) for the financial year of the purchaser preceding the purchase of the property. In the case of a nonprofit organization, “primarily engaged” means 50 percent or more of the funds allocated to the establishment are attributable to such qualifying manufacturing activities.

Recommended changes:

1. “Primarily engaged” means 50 percent or more of gross revenues, including intercompany and intracompany charges, are derived from qualifying manufacturing or research and development activities described in any qualifying NAICS classifications subdivisions (a)(1) – and (a)(3) for the financial fiscal year of the ~~purchaser~~ seller preceding the purchase of the property. For purposes of research and development activities, revenues could be derived from selling research and development services or licensing intellectual property resulting from research and development activities. In the case of a



nonprofit organization, “primarily engaged” means 50 percent or more of the funds allocated to the establishment are attributable to such qualifying manufacturing or research and development activities.

The recommended change also acknowledges that companies can sell research and development services or license their intellectual property resulting from research and development.

Test Based on Expenses

As drafted:

For purposes of determining if a purchaser is “primarily engaged” in research and development activities described in NAICS 541711 or 541712, “primarily engaged” means 50 percent or more of the expenses of the establishment are for such qualifying research and development activities as described in subdivisions (a)(2) and (a)(3) for the financial year of the purchaser preceding the purchase of the property.

Recommended changes:

Alternatively, “primarily engaged” means 50 percent or more of operating expenses are derived from qualifying manufacturing or research and development activities described in any qualifying NAICS classifications for the fiscal year of the purchaser preceding the purchase of the property. Operating expenses consist of expenses derived from the routine operation of business and should exclude non-operational expenses such as income taxes.

We recommend using the term “operating expenses” rather than “expenses”. Operating expenses should be expenses derived from the routine operation of business and should exclude items such as income taxes or payment to settle a lawsuit. Providing general guidelines will help taxpayers and auditors understand the intent of the test while contemplating the wide variety of businesses and their financial activities.

The recommendations also increase the opportunity for a taxpayer to qualify for the exemption by having the option to apply the gross revenue or expense test for both manufacturers and research and development performers.

Test Includes All Activities in Qualifying NAICS Codes

The test to determine whether “50% or more” is satisfied should include all activities described in the qualifying NAICS codes. A taxpayer should be able to combine both the manufacturing and research and development activities to determine if the test is met. Including all activities listed in the qualifying NAICS codes appears consistent with the plain reading of CRTC §6377.1(b)(6)(A) as follows:

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

We recommend including an example such as,

For purposes of this subsection, the test for Gross Revenues means that the gross revenues are derived from sales of products the qualifying person manufactures, or sells from performing research and development contracts in combination, rather than derived from other commercial activity. For instance, if a company derives 40% of its receipts from tangible personal property it manufactures (qualifying), 40% from tangible personal property manufactured by others (non-qualifying) and 20% from performance of research and



development contracts (qualifying), it would qualify because overall, 60% of the receipts are from qualifying activities.

Similarly, the test for Operating Expenses means expenses from manufacturing or research and development activities cited in the qualifying NAICS codes in combination.

Taxpayers should be able to perform all of the types of manufacturing and research and development activities listed without risk of being precluded from the exemption because a single NAICS activity is not the majority activity. CRTC §6377.1(b)(6)(A) seems to also contemplate that a qualifying taxpayer could engage in more than one NAICS-defined activity by use of the term “those lines of business” rather than stating “a line of business”. Further, CRTC §6377.1(b)(6)(A) does not appear to refer to the NAICS codes in a way that states the manufacturing group of 3111 to 3399 should be a separate class than the research and development codes of 541711 and 541712.

Recommendation to Eliminate Reference to Assets Only for R&D Qualifications

In subsection (b)(8)(A)(1) paragraph 2, we also recommend deleting the reference to “subdivisions (a)(2) and (a)(3)” which specifically refers to tangible personal property (“TPP”). TPP can be a small component compared to the labor expenses of a research and development function. Comparing only the TPP used for research and development to all other expenses would preclude most taxpayers from being a “Qualified Person”.

Qualified Person – “Line of Business”

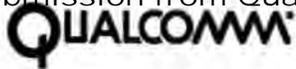
The most recent draft of Regulation §1525.4 defines a “Qualified Person” using an analysis of the income statement elements of Gross Receipts and Expenses. The measurement is at the level of “establishment”, which is deemed “a single physical location where economic activity is conducted”. This seems like a very specific test requiring data that many companies may not have readily available.

I recommend that staff use a company’s existing financial data to develop tests that will satisfy the “Qualified Person” test. It is common for companies to have income statement data at the legal entity level, and at subsets within a legal entity such as department or cost center. The companies’ internally designated subsets of financial measurements may reasonably represent a line of business more closely than a “single physical location”.

For ease of administration and inclusion we recommend a multi-tier test for “Qualified Person”. First, use the 50% or more test at the entity level for the entire entity to qualify. Second, use an economic unit that is a subset identified within the taxpayers records (i.e., cost center or department) that is reasonable and consistent with a line of business.

As drafted:

2. For purposes of classifying a line or lines of business, the economic unit shall be the "establishment" and the classification of the line or lines of business will be based on the economic activity in which the establishment is primarily engaged, establishment's single most predominant activity based upon gross revenue, including intra-company charges. An establishment is not necessarily identical with the enterprise or company which may consist of one or more establishments. Also, an establishment is to be distinguished from subunits of the establishment such as departments. The term “establishment” means a single physical location where economic activity is conducted, such as manufacturing, construction, wholesale, research and development, or other such economic activities for which the NAICS provides a code. A single physical location includes a building, interconnected structure, or other such improvement to realty. For example, a factory, mill, store, winery, warehouse, research and development building, or manufacturing plant



is generally a single physical location. If a single entity or enterprise conducts different economic activities at multiple different establishments in the same geographic area, such as a group of separate and distinct buildings arranged in a campus setting, each building or structure shall be considered a separate establishment.

Where a single establishment derives gross revenue from manufacturing activities and also engages in research and development activities at a single physical location, the two activities shall each be examined separately. That is, if 50 percent or more of gross revenue at that single establishment are from qualifying manufacturing activities or 50 percent or more of total expenses of the establishment are for qualifying research and development activities, then the establishment qualifies and all purchases of qualified tangible personal property qualify for the partial exemption.

As recommended:

3. For purposes of classifying a line or lines of business, the economic unit will be the "establishment". The term "economic unit" means a single legal entity or a subgroup within a legal entity that is tracked within the legal entity's accounting records for which separate reports can be prepared. A subgroup may include, but is not limited to, a department or a cost center. The highest level of legal entity or subgroup at which the economic unit is a qualifying person is the level to which the term "qualifying person" applies. There may be more than one "establishment" in a single legal entity.

[Remove the second paragraph and substitute the recommendation under heading Test Includes All Activities in Qualifying NAICS Codes.]

Thank you for your time and consideration regarding these comments and recommendations. If I can assist in any way, please feel free to call me and discuss any questions or comments at 858-651-8354.

Very Truly Yours,

A handwritten signature in cursive script that reads "Sandra Schaper".

Sandra Schaper
Qualcomm Incorporated



DOWNEY·SMITH·FIER
STATE & LOCAL TAX

February 27, 2014

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

Re: Comments on Proposed Regulation 1525.4 (Mfg. and R & D Partial Exemption)

Thank you for the opportunity to continue to participate in the Interested Party discussion and the drafting of the new Regulation for Manufacturing and R&D Equipment. We definitely view this as a critical and productive process and although there are no additional discussions scheduled, we are encouraged by the Board of Equalization's verbal comments during the Interested Parties Meeting ("IPM") and willingness to address the concerns surrounding the definition of a "qualified person".

Downey, Smith & Fier has the following comments related to three areas of proposed Regulation 1525.4:

1. As discussed in the February 18, 2014 IPM, DSF agrees that it is necessary to modify or expand the proposed Regulation to clearly set forth that a "qualified person" includes any business enterprise with an overall or aggregate NAICS code that falls within the prescribed range of 3111 to 3399, inclusive and 541711 or 54712, without requiring separate qualification based on any concept of establishment.

Note: This change should have little, if any, impact on the scope of the exemption as a qualified person must also support that any claimed property is "qualified property" used in a qualified activity.

2. Our second point also involves "qualified person", more specifically, the concept of "establishment" as the Board has set forth in the proposed Regulation. Again, we agree with the discussion during the IPM that the concept of "Establishment" must be easily determined by a taxpayer, consistent with the way that businesses maintain their books and records and something that can be audited. Physical location presents a significant challenge for both taxpayers to determine qualification and for State Auditors to verify as generally financial records are not maintained in this manner. Furthermore, we strongly believe that when separate and distinct economic activities are conducted within a business, the fact that those

activities are in separate or different locations should not impact the determination of a qualified person.

As discussed during the IPM, the concept of establishment may need to be different for manufacturing verses Research and Development activities.

It is our understanding that the California Taxpayers Association ("CTA") will be submitting proposed language to revise the definition of "establishment" as used in the Regulation. We also understand that CTA's proposal will be oriented towards for-profit enterprises. We recommend that any language adopted be expanded to include terminology specific to not-for-profit businesses or government organizations, such as object codes, function, grants, gifts and other types of fundings, etc.

Accordingly, we suggest the following language be included after the general definition of an establishment:

"For not-for-profit organizations or governmental entities, an establishment would include the smallest economic unit for which funding and expenditure information is maintained on activities defined in the range of NAICS codes subject to the partial exemption and be represented by, but not limited to: functions, funds, grants, gifts or other types of separate financial records."

3. Under paragraph (b)(8)(A)1., second paragraph should include the following language:

"In the case of a not-for-profit organization or governmental entity, "primarily engaged" means 50% or more of the funds allocated to the establishment are attributable to such qualifying Research and Development activities."

Thank you for your consideration.

Sincerely,



Downey, Smith & Fier ("DSF")

Cc: Lynn Whitaker

UNIVERSITY OF CALIFORNIA, LOS ANGELES

UCLA

BERKELEY • DAVIS • IRVINE • LOS ANGELES • MERCED • RIVERSIDE • SAN DIEGO • SAN FRANCISCO



SANTA BARBARA • SANTA CRUZ

February 27, 2014

UCLA TAX SERVICES
10920 WILSHIRE BLVD., 5TH FLOOR
LOS ANGELES, CALIFORNIA 90024-6502

PHONE: (310) 794-0538
FAX: (310) 794-8147
www.tax.ucla.edu

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

Re: Comments on Proposed Regulation 1525.4 (Mfg. and R & D Partial Exemption)

Dear Ms. Buehler:

On behalf of UCLA, we are very interested in the discussions that have taken place regarding the proposed language to be used in Regulation 1525.4. Downey, Smith & Fier (DSF) has been updating us on the latest developments in this process and we have participated in the Interested Parties Meetings as well. We agree with DSF's language regarding not-for-profit and governmental organizations as stated in the letter dated February 27, 2014 attached to this email. We respectfully request that the Board adopt such language in the new Regulation.

Our interest stems from the important role research plays at UCLA and how it represents a distinct function at our University. Research is one of our four core principals, along with education, patient care, and public service, and it serves as an integral part of our University's mission, operations and strategic goals. This clearly represents an economic unit in our financial records and organization, with separate accounting at a cost center/fund level for expenditures. Accordingly, the language adopted should reflect our research functions as an establishment. Based on our understanding of the current status and direction of the language to be used in the Regulation, we want to express our agreement in broadly defining an establishment and that any language should support not-for-profit and governmental entities and the way these entities maintain their financial information, including, but not limited to: function, funds, object codes, financial accounting units, etc.

Sincerely,

A handwritten signature in black ink, appearing to read "Scott Monatlik".

Scott Monatlik
Director, Tax Services
University of California, Los Angeles

February 28, 2014

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

VIA: Email: Susanne.Buehler@boe.ca.gov

Re: Proposed Regulation 1525.4 (Mfg. and R & D Partial Exemption) Comments

It was a pleasure to be able to listen in on the recent conference call/meeting for the Interested Party discussion on February 18, 2014 about the drafting of the new Regulation for Manufacturing and R&D Equipment. As a Taxpayer, ("Oakley"), we absolutely view this proposed regulation as an important process and want to make sure the Board of Equalization ("BOE") and other California Taxpayers work together to and make sure the regulation ensures all eligible persons to have an equal benefit to the regulation. Although the BOE has not scheduled any additional discussions, we believe the BOE will review all parties' comments thoroughly and willingly by addressing the concerns around the definition of a "qualified person" from all parties small and large.

Oakley has the following comments related to the proposed Regulation 1525.4:

- From the discussion during the Interested Party Meeting ("IPM"), Oakley supports the BOE for wanting to expand and revise the definition of a "qualified person". We agree with the discussion and proposed regulation describing a "qualified person", a person that is primarily engaged in those lines of a business described by the North American Industry Classification System ("NAICS") within Codes with the prescribed range of 3111 to 3399, inclusive and 541711 or 54712, without requiring separate qualification based on any concept of establishment.



OAKLEY, INC.
ONE ICON
FOOTHILL RANCH
CALIFORNIA 92610
PHONE: 949.951.0991
FAX: 949.689.3500
WWW.OAKLEY.COM

Ms. Susanne Buehler
Proposed Regulation 1525.4-Manufacturing and R&D Equipment
Comments
February 28, 2014

- As Oakley is a manufacturer in California, with multiple legal entities that surrounds the overall business of manufacturing, research and development, wholesale, and retail with multiple departments we agree that it would qualify as a "qualified person" under the definition, but also understand that not 100% of the legal entity which houses the manufacturing, research and development and other corporate functions would be able to take advantage of Regulation 1525.4 for the whole legal entity. During the IPM, we agree that the concept of "Establishment" must be easily determined by a taxpayer, consistent with the way that businesses maintain their books and records and for which something can be audited. For Oakley, we have cost centers that help support areas of manufacturing and research and development ("R&D"). We would have multiple establishments that would have some form of this area along with other non-manufacturing/R&D functions. Physical location presents a major challenge for both taxpayers to determine qualification and for BOE Auditors to verify taxpayer's books and records which are not maintained in this manner. Furthermore, we strongly believe that when separate and distinct economic activities are conducted within a business, the fact that those activities are in separate or different locations should not impact the determination of a qualified person.

Thank you for your consideration.

Sincerely,



Timothy Hall
Oakley
Tax Project Manager

Cc: Lynn Whitaker ([VIA: Email Lynn.Whitaker@boe.ca.gov](mailto:Lynn.Whitaker@boe.ca.gov))



OAKLEY, INC.
ONE ICON
FOOTHILL RANCH
CALIFORNIA 92610

PHONE: 949.951.0991
FAX: 949.699.3500
WWW.OAKLEY.COM



CALIFORNIA POULTRY FEDERATION

4640 SPYRES WAY, SUITE 4
MODESTO, CA 95356
PHONE: (209) 576-6355
FAX: (209) 576-6119
WWW.CPIF.ORG

Ms. Susanne Buehler, Chief
Tax Policy Division
Sales and Use Tax Department
450 N Street
Sacramento, CA 94279-0092

Re: Comments on Proposed Regulation 1525.4

Dear Ms. Buehler:

The California Poultry Federation is pleased to submit the following comments regarding proposed Regulation 1525.4.

The current draft of the proposed regulations issued with the Third Discussion Paper on January 31, 2014 made revisions to clarify that the definition of a "qualified person" is based on establishments within an entity rather than the entity itself. Specifically, Regulation Section 1525.4(b)(8)(A)(3) states:

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...

However, Regulation Section 1525.4(b)(8)(B) states that a qualified person does not include:

An apportioning trade or business that is required to apportion its business income pursuant to subdivision (b) of RTC section 25128... these apportioning trades or businesses derive more than 50 percent of their gross business receipts from an agricultural business activity...

Our concern is that an entity which has both agricultural operations (e.g., Code 1123) and manufacturing operations (e.g., Code 3111 or 3116) in the same entity may be prohibited from claiming the exemption. We propose that the regulations 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 RTC section 25128.

The California Poultry Federation thanks you for your consideration of our views on this issue of importance to our members.

Sincerely,

Bill Mattos
President

EXECUTIVE COMMITTEE MEMBERS AND OFFICERS

MIKE LEVENTINI, PETALUMA POULTRY PROCESSORS - CHAIRMAN • DAVID PITMAN, PITMAN FAMILY FARMS - VICE CHAIRMAN
LILLIAN ZACKY, ZACKY & SONS POULTRY - SECRETARY/TREASURER
RICHIE KING, FOSTER FARMS - PAST CHAIRMAN
BILL MATTOS, CALIFORNIA POULTRY FEDERATION - PRESIDENT