State of California

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Memorandum

To: Honorable Jerome E. Horton, Chairman
Honorable Michelle Steel, Vice Chair
Honorable Betty T. Yee, First District
Senator George Runner, Second District
Honorable John Chiang, State Controller

Date: May 8, 2014

From: Randy Ferris
Chief Counsel

Subject: Proposed Adoption of Amendments to Property Tax Rule 133, *Business Inventory Exemption*
May 22-23, 2014 Board Meeting – Item F – Public Hearing

This memorandum provides background information and legal analysis regarding the amendments to Property Tax Rule[1] 133, *Business Inventory Exemption* (Rule 133), published in the California Regulatory Notice Register on April 4, 2014, as a result of the Board's approval, at the February 25, 2014, Board meeting, to initiate the formal rulemaking process. The amendments clarify that the business inventory exemption applies to non-reusable space transportation equipment (space flight property) fabricated and used to transport satellites and cargo to locations in outer space and over which the owner relinquishes ultimate control at launch to a federal launch safety authority.

At the February 25, 2014, Board meeting, staff was asked to provide additional clarification regarding the ceding of control and additional analysis of the federal authority regarding the transfer of control.

I. Factual and Federal Authorities Background

The Commercial Space Launch Act of 1984, as codified and amended at 51 U.S.C. § 50901 et seq., authorizes the Secretary of the Department of Transportation (Secretary) to regulate commercial launch activities as carried out within the United States. (51 U.S.C. §§ 50903, 50905.) The Secretary exercises this authority through delegations to the Federal Aviation Administration (FAA). (See 64 Fed.Reg. 19586 (Apr. 21, 1999).) The FAA assesses launch operators through the licensing process and also assesses the safety of federal launch ranges. (71 Fed.Reg. 50510 (Aug. 25, 2006).) Prior to launch, a commercial launch operator is required to obtain a launch license from the FAA. (51 U.S.C. § 50904(a), 14 C.F.R. § 415.9.)

[1] All references to Property Tax Rules or Rules are to sections of title 18 of the California Code of Regulations.

The Department of the Air Force (Air Force) is the owner and operator of the two primary federal space launch base ranges (Ranges or, individually, Range) – Cape Canaveral Air Force Station, Florida and Vandenberg Air Force Base, California.[2] (Air Force Space Command Instruction (AFSPCI) 91-701, *Launch Safety Program Policy*, (June 1, 2005) (AFSPCI 91-701), ¶ 1.) It operates these bases through its Air Force Space Command. (*Ibid.*)

Pursuant to a Memorandum of Agreement between the Air Force and the FAA, both agencies work together to achieve common safety requirements for launches. (*Memorandum of Agreement Between Department of the Air Force and Federal Aviation Administration on Safety for Space Transportation and Range Activities* (MOA), January 16, 2001, as modified by MOA dated September 13, 2007.) Safety requirements are codified at 14 C.F.R. § 417 through FAA rulemaking. These rules were "necessary to codify current launch practices at Federal launch ranges . . . ." (71 Fed.Reg. 50508, 50510 (Aug. 25, 2006).) The Air Force implements the common safety requirements as they apply to launches from its Ranges. At the time of promulgation of 14 C.F.R. § 417, Air Force Space Command Manual 91-710, *Range Safety User Requirements*[3] (July 1, 2004) (AFSPCMAN 91-710), volumes 1-7, represented current safety practice at the federal launch Ranges.[4] Air Force safety requirements are also reflected in AFSPCI 91-701, and Air Force Space Command Manual 91-711, *Launch Safety Requirements for Air Force Space Command Organizations* (Feb. 1, 2007) (AFSPCMAN 91-711).

A launch operator must work together with the FAA and the Air Force to ensure public safety. (14 C.F.R. § 417.101.) The FAA has detailed specific rules that launch operators must follow to comply with its safety requirements for the issuance of a license. These rules require a launch operator planning to launch from a federal launch Range to enter into an agreement with the Range that gives it access to and use of government property and services and to comply with any requirements of the agreement. (See 14 C.F.R. § 417.13.) Therefore, a launch operator launching from a Range (Range User) must comply with Air Force safety requirements detailed in AFSPCMAN 91-710. (AFSPCMAN 91-710, vol. 1, ¶ 1.2.1.)

AFSPCMAN 91-710 makes clear that safety is a joint responsibility of the Air Force and the Range User. (AFSPCMAN 91-710, vol. 1, ¶ 2.1.) It also makes clear that Range Users are solely responsible for complying with Air Force safety requirements. (AFSPCMAN 91-701, ¶ 1.3.7.) The Air Force Space Command Commander is responsible for setting safety policy (AFSPCMAN 91-710, vol. 1, ¶ 2.2), while the Range Commander has overall authority and responsibility for public safety at Air Force Ranges (AFSPCMAN 91-710, vol. 1, ¶ 2.3.1.1). Thus, at a Range, a Range User must comply with strict federal rules relating to its launch with oversight by federal authorities. While a launch operator supplies much of the information needed by a federal launch Range for safety analysis and verification, the federal launch Range clearly staffs and controls the launch. (71 Fed.Reg. 50509 (Aug. 25, 2006).)

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[2] A third federal launch range, the Wallops Flight Facility (WFF) located in Wallops Island, Virginia, is owned and operated by the National Aeronautics and Space Administration (NASA). All operations at WFF are conducted under NASA control. (*Wallops Range User's Handbook* (WFF RUH), ¶ 2.2.)

[3] WFF safety is governed by the *Range Safety Manual for Goddard Space Flight Center (GSFC) Wallops Flight Facility (WFF)* (WFF RSM), the WFF RUH, and *NASA Procedural Requirements* (NPR). We note that the *NASA and Federal Aviation Administration Joint Program Management Plan (PMP) for the Commercial Resupply Services (CRS) Contracts-International Space Station Program* is an agreement between NASA and the FAA and is not a description of range safety and flight termination requirements.

[4] AFSPCMAN 91-710 is dated July 1, 2004. FAA rulemaking related to launch safety (14 C.F.R. § 417) became effective September 25, 2006. For one example of conformity to AFSPCMAN 91-710, see 71 C.F.R. § 50517 (explaining the FAA's requirements for a "separation distance" that matches the federal launch range terminology used in AFSPCMAN 91-710).

AFSPCMAN 91-711 defines and implements launch safety policies for all Air Force Ranges. As part of launch safety requirements, it sets forth all mission rules and flight control policies. (AFSPCMAN 91-711, ¶ 1.6.3.) The flight control mission is executed by the Mission Flight Control Officer (MFCO). (AFSPCMAN 91-711, ¶ 7.1.1.1.) Flight control of a mission begins when the system or procedures used to exercise positive control of launch vehicle flight is initiated during the launch countdown and is completed when positive control is no longer required or the capability of positive control is lost (also referred to as Flight Control End of Mission). (AFSPCMAN 91-711, ¶ 7.1.1.1 & Attachment 1.) Positive control is the continuous capability to ensure acceptable risk to the public is not exceeded throughout each stage of flight. (AFSPCMAN 91-711, Attachment 1.) The MFCO is the individual responsible for maintaining positive control of launched vehicles and initiating Range "command destruct" functions for an errant vehicle during the flight control mission. (*Ibid.*) "Command destruct" is the process in which a sequence of commands is issued that causes a launch vehicle to be destroyed. (*Ibid.*)

During the flight control mission, the MFCO's launch safety responsibilities include:

> a safety assessment of the readiness of the operation to proceed; final Launch Safety Go/No-Go recommendation; monitoring launch vehicle performance in flight; and ***serving as the sole decision-making authority and initiator of the flight termination system*** [FTS] (if required).

(AFSPCMAN 91-711, ¶ 7.1.1, emphasis added.) This requirement is repeated in AFSPCMAN 91-710, vol. 1, ¶ 2.3.5.11, which states that Range Safety[5] acts as "*the sole authority for the real-time determination and execution of flight termination.*"[6] (Italics added.) The FTS includes all components that provide the ability to terminate a launch vehicle's flight in a controlled manner, including all command termination systems, inadvertent separation destruct systems, and other systems or components used to terminate flight. (AFSPCMAN 91-711, ¶ 7.1.1 & Attachment 1.)

Range personnel must ensure that Range-managed instrumentation provides uninterrupted command capability for all flight termination systems. (AFSPCMAN 91-711, ¶ 7.1.3.) As well, a command receiver decoder (CRD)[7] must be synchronized with the designated termination command frequency from the time of FTS turn-on through Flight Control End of Mission. (*Ibid.*) Typically, the CRD is activated (or "captured") approximately one-to-two hours prior to launch.[8] At approximately five minutes to 90 seconds prior to launch, the destruct system is armed. At approximately 60 seconds to launch, Range personnel verify that the destruct system is on and give the "Go" command if the launch is ready to proceed. The MFCO is responsible for the launch commit decision from a launch safety perspective and must perform checks of instrumentation prior to accepting the system for operational launch commit. (AFSPCMAN 91-711, ¶ 7.2.1.) Until approximately five seconds prior to launch, the Range User may abort the launch. After this time, the Ranger User has no ability to stop the launch, terminate the flight, or

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[5] Range Safety is now referred to as Launch Safety. (AFSPCMAN 91-711, Intro.)

[6] A similar requirement exists for WFF. Both the WFF RSM and the WFF RUH require adherence to the safety policies and criteria defined in NPR 8715.5, *Range Flight Safety Program (updated with Change 2)*. (WFF RSM, p. 3 & WFF RUH, ¶ 2.3.1.) NPR 8715.5, ¶ 1.3.7.4 states that, for any vehicle that has an FTS, "the RSO [Range Safety Officer] or equivalent shall . . . make a flight termination decision when any aspect of the flight (including, but not limited to, vehicle or support system performance) violates preplanned termination criteria (Requirement)." Further WFF RUH, ¶ 2.2.3 provides that the "RSO has authority to stop work, hold a launch, or terminate a mission in flight if necessary."

[7] A CRD detects and translates destruct commands sent by the Range to the launch vehicle FTS.

[8] Factual information regarding rocket flight and the ceding of control to the MFCO was obtained in a phone conversation between Board Legal Staff and Phil Anderson, United Launch Alliance Vandenberg Air Force Base Range Coordinator, and in informal discussions with Vandenberg Air Force Base personnel.

control the launch vehicle. Therefore, from approximately five seconds before launch, the Range User is completely "hands off," and whether the space flight succeeds or fails, the space flight property is either spent or destroyed.[9]

Once launched, the vehicle flies according to coordinates, orbital slots, and other guidance information pre-programmed into the navigational computer system pursuant to the customer's direction. The computer systems are also pre-programmed to automatically make any necessary adjustments to reach the pre-programmed coordinates. The Range User has no ability to control the vehicle after launch, and from launch to approximately when the vehicle reaches orbital space (which is the Flight Control End of Mission if the flight is not terminated earlier), the MFCO has exclusive control over the vehicle to terminate flight and destroy the vehicle. The MFCO is responsible for making decisions concerning continued flight or flight termination, and bases that decision on interpreting real-time events, mission rules, all available data sources, and sound judgment. (AFSPCMAN 91-711, ¶ 7.1.2.)

Range personnel control also extends to aborted launches. If a launch is aborted and the status of the launch vehicle is unknown, Range personnel must assume that the vehicle may liftoff without warning and shall not release instrumentation until all launch safety requirements have been met and are no longer necessary. (AFSPCMAN 91-711, ¶ 7.3.1.) In fact, the flight safety system must remain configured in a manner that will enable the MFCO to take destruct action if necessary until he or she has received verification that the vehicle is no longer in launch configuration. (AFSPCMAN 91-711, ¶ 7.3.1.1.2.) Finally, in cases where the mission and/or launch countdown is terminated under normal circumstances, Range personnel shall not release instrumentation until all launch safety requirements have been met. (AFSPCMAN 91-711, ¶ 7.3.2.)

II. Legal Analysis

California Constitution, article XIII, section 1 provides that all property is taxable unless otherwise provided by the California Constitution or by the laws of the United States. (See also Rev. & Tax. Code, § 201.) All property includes tangible personal property. Revenue and Taxation Code[10] section 219 provides a property tax exemption for business inventories and states: "For the 1980-81 fiscal year and fiscal years thereafter, business inventories are exempt from taxation and the assessor shall not assess business inventories." "Business inventories" are defined at section 129 as including "goods intended for sale or lease in the ordinary course of business . . . ." The Property Tax Law (Rev. & Tax. Code, § 50 et seq.) does not specifically define this phrase. Rule 133, subdivision (a)(1)(A) provides that "[t]he phrase 'ordinary course of business' . . . require[s] that the property be intended for sale or lease in accordance with the regular and usual practice and method of the business of the vendor or lessor."

In interpreting the business inventory exemption, a court has stated:

> While statutes granting property tax exemptions are generally construed strictly, that approach "does not require that the narrowest possible meaning be given to words descriptive of the exemption, for a fair and reasonable interpretation must

[9] While we are aware that Range Users may be engaged in research and development with a goal of manufacturing reusable space flight property, to date, no Range User has received federal approval to put such space flight property to operational reuse.

[10] All further statutory references are to the Revenue and Taxation Code unless otherwise indicated.

> be made of all laws, with due regard for the ordinary acceptation of the language employed and the object sought to be accomplished thereby. [Citations]."

(*Transworld Systems v. County of Sonoma* (2000) 78 Cal.App.4th 713, 716 (hereafter *Transworld*).)

In determining whether property meets the definition of business inventory, courts have looked to whether sales tax is owed on transfers of property as an important factor. This is because sales tax is generally imposed on transfers of property that were held as business inventory prior to sale. Since sales tax is imposed on each retail sale (Rev. & Tax. Code, § 6051) and a retail sale is defined as "a sale for any purpose other than resale in the regular course of business" (Rev. & Tax. Code, § 6007), it necessarily follows that *prior* to a retail sale, the property is held and "intended for sale in the ordinary course of business." If that property is "intended for sale in the ordinary course of business," that property meets the section 129 definition of business inventory. In *Westinghouse Beverage Group v. County of San Diego* (1988) 203 Cal.App.3d 1442 (hereafter *Westinghouse*), at issue was whether a soft drink manufacturer's reusable containers supplied to wholesale customers were business inventory. The court, in determining that the containers were not business inventory, cited as one factor that the manufacturer did not collect sales tax reimbursement.[11] This is because if the containers were held as business inventory (i.e., "goods intended for sale in the ordinary course of business"), sales tax would have been due upon their transfer. Since sales tax was not due, the containers could not have been "goods intended for sale in the ordinary course of business" and, thus, did not meet the definition of business inventory. (See also *Amdahl Corporation v. County of Santa Clara* (2004) 116 Cal.App.4th 604 [rotable spare parts held not to be business inventory under facts where sales tax reimbursement was not collected].)

Thus, the courts have implicitly recognized that "goods intended for sale in the ordinary course of business" must have the same meaning for the same transaction. There is not one definition of inventory for sales tax purposes and a different definition of inventory for property tax purposes. Therefore, it follows that if sales tax is owed on a transfer of specified property in the ordinary course of business, then that property was "sold" in a retail sale and that same property was, prior to sale, property that was "intended for sale in the ordinary course of business" (i.e., business inventory).

"Sale" is defined broadly in the Sales and Use Tax Law to mean and include "[a]ny transfer of title or possession, exchange, or barter, conditional or otherwise, ***in any manner or by any means whatsoever***, of tangible personal property for a consideration." (RTC § 6006, subd. (a), emphasis added.) Thus, if possession is transferred for a consideration, a sale has transpired and sales tax is imposed on that transfer. In the case of space flight property, consideration is paid by the customer that requires transfer of control of the property to a federal launch safety authority. As explained above, possession of that property is transferred upon launch when the MFCO (i.e., the federal launch safety authority) takes control over the property for safety purposes. Because the federal launch safety authority has the sole discretion to destroy the property, all meaningful control is in the safety authority's hands. Such transfer at launch is a retail sale for sales tax purposes pursuant to sections 6006 and 6007. Therefore, but for a specific exemption, space flight property companies would owe sales tax on such transfers.[12]

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[11] Although sales tax is imposed on retailers, retailers may collect sales tax reimbursement from their customers as provided in Sales and Use Tax Regulation 1700, *Reimbursement for Sales Tax*. (Cal. Code Regs., tit. 18, § 1700.)

[12] Section 6380 exempts qualified property for use in space flight from sales and use tax.

Since the transfer of control to the federal launch safety authority of such property upon launch for consideration is a "sale," prior to transfer, such properties are "goods intended for sale in the ordinary course of business." Since such properties are "goods intended for sale in the ordinary course of business," they are business inventory within the meaning of sections 129 and 219 and Property Tax Rule 133. We note that this analysis also considers the heavy federal regulation under which the space flight industry must operate that restricts the transfer of title to such property.[13] This satisfies the Rule 133 requirement to construe the phrase "ordinary course of business" in accordance with "the regular and usual practice and method of the business of the vendor or lessor." (Rule 133, subd. (a)(1)(A).)

Finally, the classification of space flight property meeting the requirements of proposed Rule 133, subdivision (a)(2)(E) as business inventory is also consistent with California property tax cases considering the element of control over the property in determining whether the property qualifies for the business inventory exemption. In *Transworld, supra*, 78 Cal.App.4th 713, the court opined that property transferred with a nonprofessional service constituted business inventory since the goods were transferred away from the business pursuant to a customer's direction. Implicit in the court's reasoning was that the customer, not the business, had control, albeit indirect, of where the goods would be delivered. (See also *Westinghouse, supra*, 203 Cal.App.3d 1442 [reusable containers did not qualify as inventory since the seller retained control over the containers on the lien date even though the containers were in the physical possession of its customers].) As noted above, in the case of space flight property, all delivery coordinates are pre-programmed pursuant to the customer's direction, and all meaningful control of space flight property is transferred to the federal launch safety authority upon launch since that authority has the sole discretion to destroy the property.

Therefore, based upon the above discussion of sales and use tax and property tax law, and the heavy federal regulation which constrains the transfer of title to space flight property, space flight property for which control is ceded to the federal launch safety authority, for a consideration, is property that is intended to be sold in the ordinary course of business and is properly classified as business inventory. As business inventory, such property qualifies for the business inventory exemption under sections 129 and 219.

If you need more information or have any questions, please contact Robert Tucker, Assistant Chief Counsel, at (916) 322-0437 or Richard Moon, Tax Counsel IV, at (949) 440-3486.

Approved:

Cynthia Bridges
Executive Director

RMF:RM:hp

STATE BOARD OF EQUALIZATION

BOARD APPROVED as amended
At the May 22, 2014 Board Meeting
Joann Richmond
Joann Richmond, Chief
Board Proceedings Division

cc:	Mr. David Gau	MIC: 63
	Mr. Todd Gilman	MIC: 70
	Mr. Dean Kinnee	MIC: 64
	Mr. Robert Tucker	MIC: 82
	Mr. Richard Moon	MIC: 82

[13] See, for example, the Arms Export Control Act (22 U.S.C. § 2778) and the International Traffic in Arms Regulations (22 C.F.R. §§ 120-130).

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JOHN CHIANG
State Controller

CYNTHIA BRIDGES
Executive Director

April 4, 2014

No. 2014/016

TO COUNTY ASSESSORS, COUNTY COUNSELS,
AND OTHER INTERESTED PARTIES:

Notice of Proposed Regulatory Action
by the
State Board of Equalization

Proposed to Adopt
Amendments to California Code of Regulations, Title 18,
Section 133, *Business Inventory Exemption*

NOTICE IS HEREBY GIVEN

The State Board of Equalization (Board), pursuant to the authority vested in it by Government Code section 15606, proposes to adopt amendments to California Code of Regulations, title 18, section (Property Tax Rule) 133, *Business Inventory Exemption*. The proposed amendments to Property Tax Rule 133 clarify that space flight property, not operationally reusable, listed in the International Traffic in Arms Regulations on the United States Munitions List, and the control of which is relinquished by the owner upon launch, is classified as business inventory within the meaning of Revenue and Taxation Code (RTC) sections 129 and 219.

PUBLIC HEARING

The Board will conduct a meeting in Room 121, at 450 N Street, Sacramento, California, on May 22-23, 2014. The Board will provide notice of the meeting to any person who requests that notice in writing and make the notice, including the specific agenda for the meeting, available on the Board's website at *www.boe.ca.gov* at least 10 days in advance of the meeting.

A public hearing regarding the proposed regulatory action will be held at 10:00 a.m. or as soon thereafter as the matter may be heard on May 22 or 23, 2014. At the hearing, any interested person may present or submit oral or written statements, arguments, or contentions regarding the adoption of the proposed amendments to Property Tax Rule 133.

AUTHORITY

Government Code section 15606

REFERENCE

RTC sections 129 and 219

INFORMATIVE DIGEST/POLICY STATEMENT OVERVIEW

Current Law

California Constitution, article XIII, section 1 provides that, unless otherwise provided by the California Constitution or by the laws of the United States, all property is taxable. All property includes tangible personal property. However, RTC section 219 provides that, "For the 1980-81 fiscal year and fiscal years thereafter, business inventories are exempt from taxation and the assessor shall not assess business inventories."

Under Government Code section 15606, subdivision (c), the State Board of Equalization (Board) is authorized to prescribe rules and regulations to govern local boards of equalization and assessment appeals boards when equalizing and county assessors when assessing. Government Code section 15606, subdivision (f) authorizes the Board to prescribe "rules, regulations, instructions, and forms relating to classifications of kinds of property and evaluation procedures." The Board adopted California Code of Regulations, title 18, section (Property Tax Rule) 133, *Business Inventory Exemption*, pursuant to Government Code section 15606, to implement, interpret, and make specific the provisions, under article XIII of the California Constitution and the RTC, applicable to the exemption of business inventories.

In particular, Property Tax Rule 133 implements, interprets, and makes specific RTC sections 129 and 219. RTC section 129 defines "business inventories" as follows:

> "Business inventories" shall include goods intended for sale or lease in the ordinary course of business and shall include raw materials and work in process with respect to such goods. "Business inventories" shall also include animals and crops held primarily for sale or lease, or animals used in the production of food or fiber and feed for such animals.
>
> "Business inventories" shall not include any goods actually leased or rented on the lien date nor shall "business inventories" include business machinery or equipment or office furniture, machines or equipment, except when such property is held for sale or lease in the ordinary course of business. "Business inventories" shall not include any item held for lease which has been or is intended to be used by the lessor prior to or subsequent to the lease. "Business inventories" shall not include goods intended for sale or lease in the ordinary course of business which cannot be legally sold or leased in this state. If goods which cannot be legally sold or leased are not reported by the taxpayer pursuant to Section 441, it shall be

> conclusively presumed that the value of the goods when discovered is the value of the goods on the preceding lien date.
>
> "Business inventories" shall also include goods held by a licensed contractor and not yet incorporated into real property.

As relevant here, subdivision (a)(1) of Property Tax Rule 133 further defines the term "business inventories" and also defines the phrases "ordinary course of business" and "goods intended for sale or lease," as used in RTC section 129. The Board added the current provisions of subdivision (a)(2)(A), (C), and (D) to Property Tax Rule 133, in 2000, in order to provide a list of the specific types of property that the Board had previously determined are included within the meaning of the term "business inventories" prior to 2000. And, the Board added subdivision (a)(2)(B) to Property Tax Rule 133, in 2000, to clarify that the Board had recently determined that new and used oak barrels are business inventories, under specific circumstances.

Effects, Objectives, and Benefits of the Proposed Amendments

The transfer of control of space flight property to the federal government is required by Air Force Space Command (AFSPC). Authority over space flight property launch is granted to the Air Force via the Commercial Space Launch Act of 1984, as amended in 1988 (49 U.S.C. §§ 2601-23, October 30, 1984) which grants regulatory authority over space flight property to the Department of Transportation, which through the Federal Aviation Administration Office for Commercial Space Transportation entered into an agreement with the United States Air Force regarding the implementation of procedures for commercial space transportation and range activities. (See Memorandum of Agreement Between Department of the Air Force and Federal Aviation Administration on Safety for Space Transportation and Range Activities, at https://www.faa.gov/about/office_org/headquarters_offices/ast/media/moa.pdf (as of March 18, 2014).)

AFSPC directs safety requirements for both range users and air force space command organizations and requires that control over space flight property be transferred to a federal launch safety authority for flight termination purposes upon launch. (Chapters 6 and 7 of Launch Safety Requirements for Air Force Space Command Organizations, Air Force Space Command Manual 91-711 (February 1, 2007) (AFSPC Manual 91-711) provide mission flight control officers with power to issue flight termination commands.)
The federal launch safety authority, in its sole discretion, may terminate the flight. (AFSPC Manual 91-711, § 7.1.1.1.) Termination of the flight would result in destruction of the space flight property. Because the federal launch safety authority may, in its sole discretion, destroy the space flight property, all meaningful control over such property has been ceded to it.

Prior to December 2013, the Board had provided general guidance regarding the business inventory exemption and specific guidance regarding its application to various types of property; however, the previous Board guidance had not specifically discussed the application of the business inventory exemption to space flight property. By letter dated December 24, 2013, the Board's Legal Department opined that the business inventory exemption applies to space flight property fabricated and used to transport satellites and cargo to locations in outer space and over

which the owner relinquishes ultimate control at launch. In the letter, the Board's Legal Department also opined that Property Tax Rule 133 should be amended to specifically address the applicability of the business inventory exemption to space flight property governed by federal statutes and regulations.

As relevant here, RTC section 129 includes as business inventory "goods intended for sale . . . in the ordinary course of business." The Property Tax Law (RTC § 50 et seq.) does not specifically define this phrase. Property Tax Rule 133, subdivision (a)(1)(A) provides, however, that, "The phrase 'ordinary course of business' . . . require[s] that the property be intended for sale or lease in accordance with the regular and usual practice and method of the business of the vendor or lessor." Due to the unique nature of the space flight industry, the determination of whether space flight property is a "good intended for sale in the ordinary course of business" must be based upon all the relevant facts and circumstances and take into account the heavy federal regulation which constrains the transfer of title of space flight property. (The Arms Export Control Act (AECA) (22 U.S.C. § 2778) authorizes the President to designate items as defense articles and defense services on the United States Munitions List (Munitions List) for purposes of promulgating regulations for the import and export of such articles (22 U.S.C. § 2278, subd. (a)(1)); and the Munitions List is contained in and regulated by the International Traffic in Arms Regulations (ITAR), which places a number of requirements on any company intending to export items on the Munitions List (22 C.F.R. §§ 120-130).) Within that context, the Board's Legal Department determined that the transfer of control to the federal launch safety authority upon launch, for a consideration, is a "sale" and makes space flight property "goods intended for sale in the ordinary course of business" within the meaning of RTC sections 129 and 219 and Property Tax Rule 133. The Board's Legal Department also based its determination that space flight property is business inventory, under such circumstances, on that fact that it is consistent with the Sales and Use Tax Law (RTC § 6001 et seq.) as well as case law regarding the business inventory exemption from property tax.

In determining whether property qualifies as business inventory for property tax purposes, the Board's Legal Department found that courts have looked to whether sales tax is owed on transactions involving the property as an important factor in determining whether that property was in fact sold and intended for sale (i.e., was business inventory) prior to such sale. (See *Westinghouse Beverage Group v. County of San Diego* (1988) 203 Cal.App.3d 1442 (hereafter, *Westinghouse*) [soft drink manufacturer's reusable containers supplied to wholesale customers held not to be business inventory where manufacturer did not collect sales tax reimbursement under Cal. Code Regs., tit. 18, § 1700)]; See also *Amdahl Corporation v. County of Santa Clara* (2004) 116 Cal.App.4th 604 [sales tax reimbursement not collected on rotable spare parts – held not business inventory].) This is because sales tax is imposed on retailers and is measured by each retailer's gross receipts from each "retail sale," which is defined as "a sale for any purpose other than resale in the regular course of business." (RTC §§ 6006, 6007, and 6051.) And, it follows that if sales tax is owed on a transaction involving specified property that was entered into in the ordinary course of business, then the property was "sold" in a retail sale and that same property was necessarily, prior to sale, property that was "intended for sale in the ordinary course of business" (i.e., business inventory). Thus, the courts recognize that the definition of "goods intended for sale in the ordinary course of business" must have the same meaning for the same transaction, and thus the same definition is applicable to both sales and property tax. In other

words, there is not one definition of inventory for sales tax purposes and a different definition of inventory for property tax purposes.

In addition, under the Sales and Use Tax Law, the term "sale" means any transfer of title to or possession of property for a consideration and the term "transfer of possession" includes those transactions found by the Board to be in lieu of a transfer of title. (RTC § 6006.) Due to the unique nature of the space flight industry, the Board's Legal Department concluded that when a space flight property company transfers possession (control) of specified space flight property to the federal government at launch, for a consideration paid to the company by its customer, the transfer of possession is in lieu of a transfer of title. Accordingly, the transfer of space flight property to federal government control at launch, for a consideration, is a retail sale for sales tax purposes pursuant to RTC sections 6006 and 6007. And, but for the specific exemption for qualified property for use in space flight provided by RTC section 6380, space flight property companies would owe sales tax on such transfers. Therefore, since for sales tax purposes, a retail sale has taken place under such circumstances, it necessarily follows that such goods, prior to sale, were intended for sale in the ordinary course of business, requiring the classifying of such property as business inventory.

Furthermore, the classification of space flight property as business inventory is also consistent with California property tax cases considering the element of control over the property in determining whether the property qualifies for the business inventory exemption. For example, in *Westinghouse*, *supra*, 203 Cal.App.3d 1442, the court considered syrup and CO2 containers. It held that such containers did not qualify as inventory since the seller retained control over the containers on the lien date even though the containers were in the physical possession of its customers. The court contrasted this situation with returnable bottles in which soft drinks are sold because the bottles were not within the seller's control once sold. In *Transworld Systems v. County of Sonoma* (2000) 78 Cal.App.4th 713, 717 (hereafter, *Transworld*), the court opined that property transferred with a nonprofessional service constituted business inventory since the goods were transferred away from the business pursuant to a customer's direction. Implicit in this reasoning is that the customer, not the business, had control, albeit indirect, of where the goods would be delivered. Also, in *Transworld*, the court explained that "[w]hile statutes granting property tax exemptions are generally construed strictly, that approach 'does not require that the narrowest possible meaning be given to words descriptive of the exemption, for a fair and reasonable interpretation must be made of all laws, with due regard for the ordinary acceptation of the language employed and the object sought to be accomplished thereby. [Citations].'" (*Id.* at p. 716.) Therefore, based upon the heavy federal regulation, which constrains the transfer of title to space flight property, and the above discussion of property and sales tax law, the Board's Legal Department concluded that space flight property to which control is ceded to the federal launch safety authority, for a consideration, is property that is intended to be sold in the ordinary course of business and is properly classified as inventory. And, as inventory, such property qualifies for the business inventory exemption under the current provisions of RTC sections 129 and 219.

In Letter to Assessors (LTA) 2014/004, *Property Tax Rule 133, Business Inventory Exemption*, dated January 8, 2014, the Board's Property and Special Taxes Department advised interested parties that a project had been initiated to proposed revisions to Property Tax Rule 133 due to

"inquiries as to whether the business inventory exemption applies to certain space flight property regulated under the Arms Export Control Act (AECA) and the International Traffic in Arms Regulations (ITAR)" (footnotes omitted). The LTA also noted the Legal Department's December 24, 2013, letter regarding space flight property (discussed above), provided a link to a redacted copy of the letter posted on the Board's website, and gave the interested parties an opportunity to provide comments and suggestions by January 31, 2014.

Board staff conducted an interested parties meeting on February 6, 2014, to discuss the proposed revisions to Property Tax Rule 133. Staff subsequently prepared Formal Issue Paper 14-002, which included as attachments the comments received in support of and in opposition to Board staff's proposed amendment to Property Tax Rule 133, and submitted it to the Board for consideration during its February 25, 2014, Property Tax Committee meeting.

In the formal issue paper, Board staff recommended that the Board amend Property Tax Rule 133 to add subdivision (a)(1)(E), to clarify that space flight property, not operationally reusable and the control over which is relinquished by the owner upon launch, qualifies for the business inventory exemption. The formal issue paper recommended that the Board propose to add the following language to Property Tax Rule 133, subdivision (a)(1):

> (E) Space flight property, not operationally reusable, listed in the International Traffic in Arms Regulations on the United States Munitions List (22 CFR § 121.1), the control over which is relinquished by the owner upon launch.
>
> > (i) "Space flight" means any flight designed for suborbital, orbital, or interplanetary travel.
> >
> > (ii) The phrase "control over which is relinquished by the owner upon launch" means the transfer of control to a federal launch safety authority for space flight termination purposes.

In addition, in the formal issue paper, Board staff summarized the comments in support of and in opposition to its proposed amendments to Property Tax Rule 133. Board staff responded to the comments in opposition. Board staff also specifically explained that the proposed amendments clarifying the definition of "business inventories" will not apply to "reusable" space flight property. Board staff specifically explained that its proposed amendments are "very narrowly tailored to interpret [RTC] sections 129 and 219 to include as business inventory only spaceflight property regulated by federal statutes and regulations and for which control is relinquished upon launch." Board staff specifically explained that the proposed amendments are more limited than the exemption afforded by Assembly Bill No. (AB) 777 (2013-2014 Reg. Sess.) because Property Tax Rule 133 only applies to business inventory, while AB 777 would exempt all spaceflight property whether inventory or not. And, Board staff specifically explained that "[because the issue of the qualification of space flight property as exempt business inventory is one that has potential statewide significance and is interpretative of and consistent with existing statutes, it is the proper subject of rulemaking."

At the conclusion of the Board's discussion of Formal Issue Paper 14-002 during the February 25, 2014, Property Tax Committee meeting, the Board determined that Property Tax Rule 133 does not address the application of the business inventory exemption to space flight property, and that it is necessary to amend Property Tax Rule 133, as recommended by staff, to have the effect and accomplish the objective of addressing the application of the business inventory exemption to space flight property. Therefore, the Board agreed with staff's recommendation and the Board Members unanimously voted to propose the amendments to Property Tax Rule 133 recommended by staff, and requested that staff provide additional clarification regarding the "ceding of control" and additional analysis of the federal authority regarding the transfer of control, which is provided above and in the initial statement of reasons.

The Board anticipates that the proposed amendments to Property Tax Rule 133 will promote fairness and benefit taxpayers, Board staff, and the Board, by clarifying that RTC sections 129 and 219 apply to non-reusable space flight property, the control over which is relinquished by the owner upon launch.

The Board has performed an evaluation of whether the proposed amendments to Property Tax Rule 133 are inconsistent or incompatible with existing state regulations. The Board has determined that the proposed amendments are not inconsistent or incompatible with existing state regulations because Property Tax Rule 133 is the only regulation implementing RTC sections 129 and 219, and the proposed amendments make Property Tax Rule 133 consistent with the statutes as discussed above. In addition, the Board has determined that there are no comparable federal regulations or statutes to Property Tax Rule 133 or the proposed amendments to Property Tax Rule 133.

NO MANDATE ON LOCAL AGENCIES AND SCHOOL DISTRICTS

The Board has determined that the adoption of the proposed amendments to Property Tax Rule 133 will not impose a mandate on local agencies or school districts, including a mandate that is required to be reimbursed under part 7 (commencing with section 17500) of division 4 of title 2 of the Government Code.

NO COST OR SAVINGS TO STATE AGENCIES, LOCAL AGENCIES, AND SCHOOL DISTRICTS

The Board has determined that the adoption of the proposed amendments to Property Tax Rule 133 will result in no direct or indirect cost or savings to any state agency, cost to local agencies or school districts that is required to be reimbursed under part 7 (commencing with section 17500) of division 4 of title 2 of the Government Code, other non-discretionary cost or savings imposed on local agencies, or cost or savings in federal funding to the State of California.

NO SIGNIFICANT STATEWIDE ADVERSE ECONOMIC IMPACT DIRECTLY AFFECTING BUSINESS

The Board has made an initial determination that the adoption of the proposed amendments to Property Tax Rule 133 will not have a significant, statewide adverse economic impact directly

affecting business, including the ability of California businesses to compete with businesses in other states.

The adoption of the proposed amendments to Property Tax Rule 133 may affect small business.

NO COST IMPACTS TO PRIVATE PERSONS OR BUSINESSES

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

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

The Board has prepared the economic impact assessment required by Government Code section 11346.3, subdivision (b)(1), and included it in the initial statement of reasons. The Board has determined that the adoption of the proposed amendments to Property Tax Rule 133 will neither create nor eliminate jobs in the State of California nor result in the elimination of existing businesses nor create or expand business in the State of California. Furthermore, the Board has determined that the adoption of the proposed amendments to Property Tax Rule 133 will not affect the benefits of Property Tax Rule 133 to the health and welfare of California residents, worker safety, or the state's environment.

NO SIGNIFICANT EFFECT ON HOUSING COSTS

Adoption of the proposed amendments to Property Tax Rule 133 will not have a significant effect on housing costs.

DETERMINATION REGARDING ALTERNATIVES

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

CONTACT PERSONS

Questions regarding the substance of the proposed amendments should be directed to Leslie Ang, Tax Counsel, by telephone at (916) 323-9856, by e-mail at leslie.ang@boe.ca.gov, or by mail at State Board of Equalization, Attn: Leslie Ang, MIC:82, 450 N Street, P.O. Box 942879, Sacramento, CA 94279-0082.

Written comments for the Board's consideration, notice of intent to present testimony or witnesses at the public hearing, and inquiries concerning the proposed administrative action should be directed to Mr. Rick Bennion, Regulations Coordinator, by telephone at (916) 445-

2130, by fax at (916) 324-3984 , by e-mail at Richard.Bennion@boe.ca.gov, or by mail at State Board of Equalization, Attn: Rick Bennion, MIC:80, 450 N Street, P.O. Box 942879, Sacramento, CA 94279-0080.

WRITTEN COMMENT PERIOD

The written comment period ends at 10:00 a.m. on May 22, 2014, or as soon thereafter as the Board begins the public hearing regarding the proposed amendments to Property Tax Rule 133 during the May 22-23, 2014, Board meeting. Written comments received by Mr. Rick Bennion at the postal address, email address, or fax number provided above, prior to the close of the written comment period, will be presented to the Board and the Board will consider the statements, arguments, and/or contentions contained in those written comments before the Board decides whether to adopt the proposed amendments to Property Tax Rule 133. The Board will only consider written comments received by that time.

AVAILABILITY OF INITIAL STATEMENT OF REASONS AND TEXT OF PROPOSED REGULATION

The Board has prepared an underline and strikeout version of the text of Property Tax Rule 133 illustrating the express terms of the proposed amendments and an initial statement of reasons for the adoption of the proposed amendments, which includes the economic impact assessment required by Government Code section 11346.3, subdivision (b)(1). These documents and all the information on which the proposed amendments are based are available to the public upon request. The rulemaking file is available for public inspection at 450 N Street, Sacramento, California. The express terms of the proposed amendments and the initial statement of reasons are also available on the Board's website at *www.boe.ca.gov*.

SUBSTANTIALLY RELATED CHANGES PURSUANT TO GOVERNMENT CODE SECTION 11346.8

The Board may adopt the proposed amendments to Property Tax Rule 133 with changes that are nonsubstantial or solely grammatical in nature, or sufficiently related to the original proposed text that the public was adequately placed on notice that the changes could result from the originally proposed regulatory action. If a sufficiently related change is made, the Board will make the full text of the proposed amendments, with the change clearly indicated, available to the public for at least 15 days before adoption. The text of the resulting amendments will be mailed to those interested parties who commented on the original proposed amendments orally or in writing or who asked to be informed of such changes. The text of the resulting amendments will also be available to the public from Mr. Bennion. The Board will consider written comments on the resulting amendments that are received prior to adoption.

April 4, 2014

AVAILABILITY OF FINAL STATEMENT OF REASONS

If the Board adopts the proposed amendments to Property Tax Rule 133, the Board will prepare a final statement of reasons, which will be made available for inspection at 450 N Street, Sacramento, California, and available on the Board's website at *www.boe.ca.gov*.

Sincerely,

Joann Richmond

Joann Richmond, Chief
Board Proceedings Division

JR:reb

Initial Statement of Reasons for

Proposed Amendments to California Code of Regulations,

Title 18, Section 133, *Business Inventory Exemption*

SPECIFIC PURPOSE AND NECESSITY

Current Law

California Constitution, article XIII, section 1 provides that, unless otherwise provided by the California Constitution or by the laws of the United States, all property is taxable. (See also Rev. & Tax. Code, § 201.) All property includes tangible personal property. However, Revenue and Taxation Code (RTC) section 219 provides that, "For the 1980-81 fiscal year and fiscal years thereafter, business inventories are exempt from taxation and the assessor shall not assess business inventories."

Under Government Code section 15606, subdivision (c), the State Board of Equalization (Board) is authorized to prescribe rules and regulations to govern local boards of equalization and assessment appeals boards when equalizing and county assessors when assessing. Government Code section 15606, subdivision (f) authorizes the Board to prescribe "rules, regulations, instructions, and forms relating to classifications of kinds of property and evaluation procedures." The Board adopted California Code of Regulations, title 18, section (Property Tax Rule) 133, *Business Inventory Exemption*, pursuant to Government Code section 15606, to implement, interpret, and make specific the provisions, under article XIII of the California Constitution and the Revenue and Taxation Code, applicable to the exemption of business inventories.

In particular, Property Tax Rule 133 implements, interprets, and makes specific RTC sections 129 and 219. RTC section 129 defines "business inventories" as follows:

> "Business inventories" shall include goods intended for sale or lease in the ordinary course of business and shall include raw materials and work in process with respect to such goods. "Business inventories" shall also include animals and crops held primarily for sale or lease, or animals used in the production of food or fiber and feed for such animals.
>
> "Business inventories" shall not include any goods actually leased or rented on the lien date nor shall "business inventories" include business machinery or equipment or office furniture, machines or equipment, except when such property is held for sale or lease in the ordinary course of business. "Business inventories" shall not include any item held for lease which has been or is intended to be used by the lessor prior to or subsequent to the lease. "Business inventories" shall not include goods intended for sale or lease in the ordinary course of business which cannot

> be legally sold or leased in this state. If goods which cannot be legally sold or leased are not reported by the taxpayer pursuant to Section 441, it shall be conclusively presumed that the value of the goods when discovered is the value of the goods on the preceding lien date.
>
> "Business inventories" shall also include goods held by a licensed contractor and not yet incorporated into real property.

As relevant here, subdivision (a)(1) of Property Tax Rule 133 further defines the term "business inventories" and also defines the phrases "ordinary course of business" and "goods intended for sale or lease," as used in RTC section 129. The Board added the current provisions of subdivision (a)(2)(A), (C), and (D) to Property Tax Rule 133, in 2000, in order to provide a list of the specific types of property that the Board had previously determined are included within the meaning of the term "business inventories" prior to 2000. And, the Board added subdivision (a)(2)(B) to Property Tax Rule 133, in 2000, to clarify that the Board had recently determined that new and used oak barrels are business inventories, under specific circumstances.

Proposed Amendments

Need for Clarification

The transfer of control of space flight property to the federal government is required by Air Force Space Command (AFSPC).[1] AFSPC directs safety requirements for both range users and air force space command organizations and requires that control over space flight property be transferred to a federal launch safety authority for flight termination purposes upon launch.[2] The federal launch safety authority, in its sole discretion, may terminate the flight.[3] Termination of the flight would result in destruction of the space flight property. Because the federal launch safety authority may, in its sole discretion, destroy the space flight property, all meaningful control over such property has been ceded to it.

Prior to December 2013, the Board had provided general guidance regarding the business inventory exemption and specific guidance regarding its application to various types of property; however, the previous Board guidance had not specifically discussed the

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[1] Authority over space flight property launch is granted to the Air Force via the Commercial Space Launch Act of 1984, as amended in 1988 (49 U.S.C. §§ 2601-23, October 30, 1984) which grants regulatory authority over space flight property to the Department of Transportation, which through the Federal Aviation Administration Office for Commercial Space Transportation entered into an agreement with the United States Air Force regarding the implementation of procedures for commercial space transportation and range activities. (See Memorandum of Agreement Between Department of the Air Force and Federal Aviation Administration on Safety for Space Transportation and Range Activities, at https://www.faa.gov/about/office_org/headquarters_offices/ast/media/moa.pdf (as of March 18, 2014).)

[2] Chapters 6 and 7 of Launch Safety Requirements for Air Force Space Command Organizations, Air Force Space Command Manual 91-711 (February 1, 2007) (AFSPC Manual 91-711) provide mission flight control officers with power to issue flight termination commands.

[3] AFSPC Manual 91-711, § 7.1.1.1.

application of the business inventory exemption to space flight property. By letter dated December 24, 2013, the Board's Legal Department opined that the business inventory exemption applies to space flight property fabricated and used to transport satellites and cargo to locations in outer space and over which the owner relinquishes ultimate control at launch. In the letter, the Board's Legal Department also noted that Property Tax Rule 133 should be amended to specifically address the applicability of the business inventory exemption to space flight property governed by federal statutes and regulations.

As relevant here, RTC section 129 includes as business inventory "goods intended for sale . . . in the ordinary course of business." The Property Tax Law (RTC § 50 et seq.) does not specifically define this phrase. Property Tax Rule 133, subdivision (a)(1)(A) provides, however, that, "The phrase 'ordinary course of business' . . . require[s] that the property be intended for sale or lease in accordance with the regular and usual practice and method of the business of the vendor or lessor." Due to the unique nature of the space flight industry, the determination of whether space flight property is a "good intended for sale in the ordinary course of business" must be based upon all the relevant facts and circumstances and take into account the heavy federal regulation which constrains the transfer of title of space flight property.[4] Within that context, the Board's Legal Department determined that the transfer of control to the federal launch safety authority upon launch, for a consideration, is a "sale" and makes space flight property "goods intended for sale in the ordinary course of business" within the meaning of RTC sections 129 and 219 and Property Tax Rule 133. The Board's Legal Department also based its determination that space flight property is business inventory, under such circumstances, on that fact that it is consistent with the Sales and Use Tax Law (RTC § 6001 et seq.) as well as case law regarding the business inventory exemption from property tax.

In determining whether property qualifies as business inventory for property tax purposes, the Board's Legal Department found that courts have looked to whether sales tax is owed on transactions involving the property as an important factor in determining whether that property was in fact sold and intended for sale (i.e., was business inventory) prior to such sale. (See *Westinghouse Beverage Group v. County of San Diego* (1988) 203 Cal.App.3d 1442 (hereafter, *Westinghouse*) [soft drink manufacturer's reusable containers supplied to wholesale customers held not to be business inventory where manufacturer did not collect sales tax reimbursement[5]]; See also *Amdahl Corporation v. County of Santa Clara* (2004) 116 Cal.App.4th 604 [sales tax reimbursement not collected on rotable spare parts – held not business inventory].) This is because sales tax is imposed on retailers and is measured by each retailer's gross receipts from each "retail

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[4] The Arms Export Control Act (AECA) (22 U.S.C. § 2778) authorizes the President to designate items as defense articles and defense services on the United States Munitions List (Munitions List) for purposes of promulgating regulations for the import and export of such articles. (22 U.S.C. § 2278, subd. (a)(1).) The Munitions List is contained in and regulated by the International Traffic in Arms Regulations (ITAR), which places a number of requirements on any company intending to export items on the Munitions List. (22 C.F.R. §§ 120-130.)

[5] Although sales tax is imposed on retailers, retailers may collect sales tax reimbursement from their customers as provided in Sales and Use Tax Regulation 1700, *Reimbursement for Sales Tax*. (Cal. Code Regs., tit. 18, § 1700.)

sale," which is defined as "a sale for any purpose other than resale in the regular course of business." (RTC §§ 6006, 6007, and 6051.) And, it follows that if sales tax is owed on a transaction involving specified property that was entered into in the ordinary course of business, then the property was "sold" in a retail sale and that same property was necessarily, prior to sale, property that was "intended for sale in the ordinary course of business" (i.e., business inventory). Thus, the courts recognize that the definition of "goods intended for sale in the ordinary course of business" must have the same meaning for the same transaction, and thus the same definition is applicable to both sales and property tax. In other words, there is not one definition of inventory for sales tax purposes and a different definition of inventory for property tax purposes.

In addition, under the Sales and Use Tax Law, the term "sale" means any transfer of title to or possession of property for a consideration and the term "transfer of possession" includes those transactions found by the Board to be in lieu of a transfer of title. (RTC § 6006.) Due to the unique nature of the space flight industry, the Board's Legal Department concluded that when a space flight property company transfers possession (control) of specified space flight property to the federal government at launch, for a consideration paid to the company by its customer, the transfer of possession is in lieu of a transfer of title. Accordingly, the transfer of space flight property to federal government control at launch, for a consideration, is a retail sale for sales tax purposes pursuant to RTC sections 6006 and 6007. And, but for a specific exemption, space flight property companies would owe sales tax on such transfers.[6] Therefore, since for sales tax purposes, a retail sale has taken place under such circumstances, it necessarily follows that such goods, prior to sale, were intended for sale in the ordinary course of business, requiring the classifying of such property as business inventory.

Furthermore, the classification of space flight property as business inventory is also consistent with California property tax cases considering the element of control over the property in determining whether the property qualifies for the business inventory exemption. For example, in *Westinghouse*, *supra*, 203 Cal.App.3d 1442, the court considered syrup and CO2 containers. It held that such containers did not qualify as inventory since the seller retained control over the containers on the lien date even though the containers were in the physical possession of its customers. The court contrasted this situation with returnable bottles in which soft drinks are sold because the bottles were not within the seller's control once sold. In *Transworld Systems v. County of Sonoma* (2000) 78 Cal.App.4th 713, 717 (hereafter, *Transworld*), the court opined that property transferred with a nonprofessional service constituted business inventory since the goods were transferred away from the business pursuant to a customer's direction. Implicit in this reasoning is that the customer, not the business, had control, albeit indirect, of where the goods would be delivered. Also, in *Transworld*, the court explained that "[w]hile statutes granting property tax exemptions are generally construed strictly, that approach 'does not require that the narrowest possible meaning be given to words descriptive of the exemption, for a fair and reasonable interpretation must be made of all laws, with due regard for the ordinary acceptation of the language employed and the object sought to be accomplished thereby. [Citations].'" (*Id.* at p. 716.) Therefore, based upon the heavy

[6] RTC section 6380 exempts qualified property for use in space flight from sales and use tax.

federal regulation, which constrains the transfer of title to space flight property, and the above discussion of property and sales tax law, the Board's Legal Department concluded that space flight property to which control is ceded to the federal launch safety authority, for a consideration, is property that is intended to be sold in the ordinary course of business and is properly classified as inventory. And, as inventory, such property qualifies for the business inventory exemption under the current provisions of RTC sections 129 and 219.

Interested Parties Process and Property Tax Committee Meeting

In Letter to Assessors (LTA) 2014/004, *Property Tax Rule 133, Business Inventory Exemption*, dated January 8, 2014, the Board's Property and Special Taxes Department advised interested parties that a project had been initiated to propose revisions to Property Tax Rule 133 due to "inquiries as to whether the business inventory exemption applies to certain space flight property regulated under the Arms Export Control Act (AECA) and the International Traffic in Arms Regulations (ITAR)" (footnotes omitted). The LTA also noted the Legal Department's December 24, 2013, letter regarding space flight property (discussed above), provided a link to a redacted copy of the letter posted on the Board's website, and gave the interested parties an opportunity to provide comments and suggestions by January 31, 2014.

Board staff conducted an interested parties meeting on February 6, 2014, to discuss the proposed revisions to Property Tax Rule 133. Staff subsequently prepared Formal Issue Paper 14-002, which included as attachments the comments received in support of and in opposition to Board staff's proposed amendments to Property Tax Rule 133, and submitted it to the Board for consideration during its February 25, 2014, Property Tax Committee meeting.

In the formal issue paper, Board staff recommended that the Board amend Property Tax Rule 133 to add subdivision (a)(1)(E), to clarify that space flight property, not operationally reusable and the control over which is relinquished by the owner upon launch, qualifies for the business inventory exemption. The formal issue paper recommended that the Board propose to add the following language to Property Tax Rule 133, subdivision (a)(1):

> (E) Space flight property, not operationally reusable, listed in the International Traffic in Arms Regulations on the United States Munitions List (22 CFR § 121.1), the control over which is relinquished by the owner upon launch.
>
> > (i) "Space flight" means any flight designed for suborbital, orbital, or interplanetary travel.
> >
> > (ii) The phrase "control over which is relinquished by the owner upon launch" means the transfer of control to a federal launch safety authority for space flight termination purposes.

In addition, in the formal issue paper, Board staff summarized the comments in support of and in opposition to its proposed amendments to Property Tax Rule 133. Board staff responded to the comments in opposition (and those responses are hereby incorporated by reference). Board staff also specifically explained that the proposed amendments clarifying the definition of "business inventories" will not apply to "reusable" space flight property. Board staff specifically explained that its proposed amendments are "very narrowly tailored to interpret [RTC] sections 129 and 219 to include as business inventory only spaceflight property regulated by federal statutes and regulations and for which control is relinquished upon launch." Board staff specifically explained that the proposed amendments are more limited than the exemption afforded by Assembly Bill No. (AB) 777 (2013-2014 Reg. Sess.) because Property Tax Rule 133 only applies to business inventory, while AB 777 would exempt all space flight property whether inventory or not. And, Board staff specifically explained that "[b]ecause the issue of the qualification of space flight property as exempt business inventory is one that has potential statewide significance and is interpretative of and consistent with existing statutes, it is the proper subject of rulemaking."

At the conclusion of the Board's discussion of Formal Issue Paper 14-002 during the February 25, 2014, Property Tax Committee meeting, the Board determined that there is an issue (or problem within the meaning of Gov. Code, § 11346.2. subd. (b)(1)) because Property Tax Rule 133 does not address the application of the business inventory exemption to space flight property, and that it is reasonably necessary to amend Property Tax Rule 133, as recommended by staff, for the specific purpose of addressing that issue. Therefore, the Board agreed with staff's recommendation and the Board Members unanimously voted to propose the amendments to Property Tax Rule 133 recommended by staff, and requested staff to provide additional clarification regarding the "ceding of control" and additional analysis of the federal authority requiring the transfer of control, which is provided above.

The Board anticipates that the proposed amendments to Property Tax Rule 133 will promote fairness and benefit taxpayers, Board staff, and the Board, by clarifying that RTC sections 129 and 219 apply to non-reusable space flight property, the control over which is relinquished by the owner upon launch.

The proposed amendments to Property Tax Rule 133 were not mandated by federal law or regulations. There is no previously adopted or amended federal regulation that is identical to Property Tax Rule 133.

DOCUMENTS RELIED UPON

The Board relied upon Formal Issue Paper 14-002, the attachments to the issue paper, and the comments made during the Board's discussion of the issue paper during its February 25, 2014, Property Tax Committee meeting in deciding to propose the amendments to Property Tax Rule 133 described above.

ALTERNATIVES CONSIDERED

The Board considered whether to begin the formal rulemaking process to adopt the proposed amendments to Property Tax Rule 133 at this time or, alternatively, whether to take no action at this time. The Board decided to begin the formal rulemaking process to adopt the proposed amendments at this time because the Board determined that the proposed amendments are reasonably necessary for the reasons set forth above.

The Board did not reject any reasonable alternative to the proposed amendments to Property Tax Rule 133 that would lessen any adverse impact the proposed action may have on small business or that would be less burdensome and equally effective in achieving the purposes of the proposed action. No reasonable alternative has been identified and brought to the Board's attention that would lessen any adverse impact the proposed action may have on small business, be more effective in carrying out the purposes for which the action is proposed, would be as effective and less burdensome to affected private persons than the proposed action, or would be more cost effective to affected private persons and equally effective in implementing the statutory policy or other provision of law than the proposed action.

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

The proposed amendments to Property Tax Rule 133 clarify that, under current law, the business inventory exemption applies to space flight property, under specified circumstances. The proposed amendments are consistent with the current provisions of RTC sections 129 and 219 and the cases applying those sections, the current provisions of Property Tax Rule 133, and the Sales and Use Tax Law. And, the Board anticipates that the proposed amendments will promote fairness and benefit taxpayers, Board staff, and the Board, by clarifying that RTC sections 129 and 219 apply to non-reusable space flight property, the control over which is relinquished by the owner upon launch.

As a result, the Board estimates that the proposed amendments will not have a measurable economic impact on individuals and business that is in addition to whatever economic impact the enactment of RTC sections 129 and 219 has had and will have on individuals and businesses. And, the Board has determined that the proposed amendments to Property Tax Rule 133 are not a major regulation, as defined in Government Code section 11342.548 and California Code of Regulations, title 1, section 2000, because the Board has estimated that the proposed amendments will not have an economic impact on California business enterprises and individuals in an amount exceeding fifty million dollars ($50,000,000) during any 12-month period. Also, based on the above information and all the information in the rulemaking file, the Board has determined that the adoption of the proposed amendments to Property Tax Rule 133 will neither create nor eliminate jobs in the State of California nor result in the elimination of existing businesses nor create or expand business in the State of California.

In addition, Property Tax Rule 133 does not regulate the health and welfare of California residents, worker safety, or the state's environment. Therefore, the Board has also determined that the adoption of the proposed amendments to Property Tax Rule 133 will not affect the benefit of Property Tax Rule 133 to the health and welfare of California residents, worker safety, or the state's environment.

The forgoing information also provides the factual basis for the Board's initial determination that the adoption of the proposed amendments to Property Tax Rule 133 will not have a significant adverse economic impact on business.

The proposed amendments may affect small businesses.

Text of Proposed Amendments to

California Code of Regulations, Title 18, Section 133

133. Business Inventory Exemption.

(a) Scope of Exemption.

(1) "Business inventories" that are eligible for exemption from taxation under Section 129 of the Revenue and Taxation Code include all tangible personal property, whether raw materials, work in process or finished goods, which will become a part of or are themselves items of personalty held for sale or lease in the ordinary course of business.

(A) The phrase "ordinary course of business" does not constitute a limitation on the type of property which may be held for sale or lease, but it does require that the property be intended for sale or lease in accordance with the regular and usual practice and method of the business of the vendor or lessor.

(B) The phrase "goods intended for sale or lease" means property acquired, manufactured, produced, processed, raised or grown which is already the subject of a contract of sale or which is held and openly offered for sale or lease or will be so held and offered for sale or lease at the time it becomes a marketable product. Property which is ready for sale or lease must be displayed, advertised or otherwise brought to the attention of the potential purchasers or lessees by means normally employed by vendors or lessors of the product.

(2) "Business inventories" includes:

(A) Containers or container material such as kegs, bottles, cases, twine and wrapping paper, whether returnable or not, if title thereto will pass to the purchaser or lessee of the product to be sold or leased therein.

(B) New and used oak barrels used in the manufacturing process that physically incorporate the flavor- and aroma-enhancing chemical compounds of the oak into wine or brandy to be sold, when used for this purpose. However, an oak barrel is no longer business inventory once it loses the ability to impart the chemical compounds that enhance the flavor and aroma of the wine or brandy. An "oak barrel" used in the manufacturing process is defined as having a capacity of 212 gallons or less. Oak barrels not used in the manufacturing process but held for sale in the ordinary course of business are also considered business inventory.

(C) Materials such as lumber, cement, nails, steel beams, columns, girders, etc., held by a licensed contractor for incorporation into real property, providing the real property will not be retained for the licensed contractor's use.

(D) Crops and animals held primarily for sale or lease and animals used in the production of food or fiber and feed for animals in either category.

(E) Space flight property, not operationally reusable, listed in the International Traffic in Arms Regulations on the United States Munitions List (22 CFR § 121.1), the control over which is relinquished by the owner upon launch.

(i) "Space flight" means any flight designed for suborbital, orbital, or interplanetary travel.

(ii) The phrase "control over which is relinquished by the owner upon launch" means the transfer of control to a federal launch safety authority for space flight termination purposes.

(b) Exclusions. Property eligible for the "business inventories" exemption does not include:

(1) Property of any description in the hands of a vendee, lessee or other recipient on the lien date which has been purchased, leased, rented, or borrowed primarily for use by the vendee, lessee or other recipient of the property rather than for sale or lease or for physical incorporation into a product which is to be sold or leased. Examples of property excluded from business inventories are office supplies, furniture, machines and equipment and manufacturing machinery, equipment and supplies such as dies, patterns, jigs, tooling or chemicals used to produce a chemical or physical reaction, and contractors' supplies, tools, concrete forms, and other items that will not be incorporated into and become a part of the property. Also ineligible are materials that a contractor is holding to incorporate into real property that will be retained for his own use.

(2) Property being used by its owner for any purpose not directly associated with the prospective sale or lease of that property.

(3) Property actually leased or rented on the lien date.

(4) Property which has been used by the holder prior to the lien date, even though held for lease on the lien date.

(5) Property intended to be used by the lessor after being leased or during intervals between leases even though held for lease on the lien date.

(6) Property in the hands of a lessor who, with intent to enjoy the benefits of the inventory exemption, had leased the property for a period that expired shortly before the lien date but who renewed, extended or renegotiated the lease shortly thereafter.

(c) Service Enterprises. Property held by a person in connection with a profession which is primarily a service activity such as medicine, law, architecture or accountancy is not "business inventories" held for sale or lease even though such property may be transferred to a patient or client incidental to the rendition of the professional service. Property held by enterprises rendering services of a nonprofessional type such as dry cleaners, beauty shop operators and swimming pool service companies is to be regarded as "business inventories" held for sale if such property is delivered as an item regularly included in the service.

(d) Repairers and Reconditioners. Persons engaged in repairing or reconditioning tangible personal property with the intent of transferring parts and materials shall be regarded as holding said parts and materials as "business inventories."

(e) Agricultural Enterprises. Animals, crops and feed held primarily for sale or lease in the ordinary course of business are included in the term "business inventories," as are animals used in the production of food or fiber and feed for such animals.

(1) "Animals used in the production of food and fiber" includes all animals customarily employed in the raising of crops or for the feeding, breeding and management of livestock, or for dairying, or any other confined animals whose products are normally used as food for human consumption or for the production of fiber useful to man. Excluded are animals held by an owner or lessee principally for sport, recreation or pleasure such as show animals, horses held for racing or horses and other animals kept as pets.

(2) The term "crops" means all products grown, harvested, and held primarily for sale, including seeds held for sale or seeds to be used in the production of a crop which is to be held primarily for sale. It does not include growing crops exempted pursuant to Article XIII, section 3(h), of the California Constitution or fruit trees, nut trees, and grapevines exempted by section 223 of the Revenue and Taxation Code.

(3) The term "food" means property normally considered as food for human consumption.

(4) Feed for animals held primarily for sale or lease or for animals used in the production of food or fiber constitutes "business inventories" subject to exemption. It includes every type of natural-grown or commercial product fed to animals except medicinal commodities intended to prevent or cure disease unless the medicinal commodities are purchased as a component part of feed for such animals.

Note: Authority cited: Section 15606, Government Code. Reference: Sections 129 and 219, Revenue and Taxation Code.

Regulation History

Type of Regulation: Property Tax

Rule: 133

Title: *Business Inventory Exemption*

Preparation: Leslie Ang
Legal Contact: Leslie Ang

The proposed amendments clarify that the business inventory exemption applies to space flight property, under specific circumstances.

History of Proposed Regulation:

May 22, 2014	Public Hearing
April 4, 2014	OAL publication date; 45-day public comment period begins; Interested Parties mailing
March 25, 2014	Notice to OAL
February 25, 2014	Property Tax Committee, Board Authorized Publication (Vote 5-0)

Sponsor: NA
Support: Capitol Strategies Group, Commercial Spaceflight Federation, Los Angeles County Economic Development Corporation, Reliance Machine Products, Inc., United Launch Alliance, Westco Aircraft Hardware Corp.

Oppose: California Assessors' Association, Los Angeles County Assessor, Santa Clara County Assessor