



STATE BOARD OF EQUALIZATION

450 N STREET, SACRAMENTO, CALIFORNIA
PO BOX 942879, SACRAMENTO, CALIFORNIA 94279-0082
949-440-3486 • FAX 916-323-3387
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

December 24, 2013

**Re: Business Inventory Exemption – Space Exploration Technologies Corporation
Assignment No.: 13-253**

Dear Mr. _____ :

This is in response to your request for an opinion regarding the applicability of the business inventory exemption to space transportation equipment (Equipment) fabricated by Space Exploration Technologies Corporation (SpaceX) and used to transport satellites and cargo to locations in outer space, and over which SpaceX must relinquish ultimate control at launch.¹ As explained below, it is our opinion that such Equipment qualifies for the business inventory exemption. Although SpaceX does not facially structure its contracts as a sale or lease of the Equipment, SpaceX is constrained by federal statutes and regulations which impede the market for the purchase and sale of such equipment. In our opinion, within the context of the federal statutory and regulatory scheme within which SpaceX is required to operate, its contracts and business practices demonstrate that Equipment fabricated by SpaceX qualifies for the business inventory exemption.²

Factual Background

SpaceX's business primarily consists of delivery of satellites to locations in space and cargo to the International Space Station. With respect to satellite delivery, SpaceX contracts with commercial or government customers who hire it to fabricate Equipment, design the interface specifications to match their satellite, and deliver the satellite to an "orbital slot" or other location in space at which the payload will be released. SpaceX Equipment consists primarily of two types of launch vehicles, the "Falcon 9" and the "Falcon Heavy," and a Dragon capsule (Capsule). All Equipment is built to order, but the Equipment itself is not generally customized. However, the interface that connects the launch vehicle or the Capsule to the customer's payload is customized for each mission according to the customer's required specifications.

¹ We understand that you have filed an assessment appeal in Los Angeles County. We have contacted the Los Angeles County Assessor's Office and offered them an opportunity to provide input.

² Because Property Tax Rule 133, which governs the business inventory exemption, does not contemplate an industry as unique and heavily regulated by the federal government as the commercial space flight industry, we believe Rule 133 should be amended to specifically address space flight property governed by the Arms Control Export Act and the International Traffic in Arms Regulations.

Pursuant to SpaceX's contract for fabrication of Equipment and launch services, SpaceX customers do not receive title to the Equipment. However, the contracts are drafted, as required by federal law, such that SpaceX cedes ultimate control of the Equipment at launch to a federal Range Safety Officer at the launch site. After delivery of the payload, the Equipment is generally burned up in space or becomes space junk.³

For financial accounting purposes, SpaceX treats its Equipment as inventory, increasing inventory when Equipment is manufactured and decreasing inventory when Equipment is launched.

Law and Analysis

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, Revenue and Taxation Code⁴ 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."

Section 129 states that business inventories include "goods intended for sale or lease in the ordinary course of business and shall include raw materials and work in progress with respect to such goods. . . ." Property Tax Rule⁵ 133, subdivision (a)(1) provides:

"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.

³ For missions that include a Capsule that returns to Earth (e.g., missions where items are being transported from the International Space Station to Earth, after coordinating with NASA, SpaceX typically stores such consumed Capsules at SpaceX's location in McGregor, TX as museum-type pieces. The Capsules are currently not reusable.

⁴ All further statutory references are to the Revenue and Taxation Code unless otherwise indicated.

⁵ References to "Property Tax Rules" or "Rule" are section references to title 18 of the California Code of Regulations.

Therefore, in order to qualify for the business inventory exemption, goods must be intended for sale or lease in the ordinary course of business. A "sale" is generally defined as the passage of title from seller to buyer for a contract price.⁶ According to this general definition, SpaceX does not sell its Equipment to its customers.⁷ Ordinarily, this would preclude such property from qualifying for the business inventory. (See *Amdahl Corporation v. County of Santa Clara* (2004) 116 Cal.App.4th 604 (*Amdahl*) [Rule 133 read as a whole requires that goods be held for sale in the regular course of business].) However, in this case, we believe that SpaceX's services must be viewed in light of the fact that it operates in an industry that is heavily regulated by the federal government and, as a practical matter, is greatly restricted with respect to the possibility of transferring title to its Equipment to customers.

The United States regulates the export of certain goods and technologies broadly related to national defense through a number of laws and regulations that involve multiple federal agencies, including the Department of State, the military, NASA and the intelligence agencies. Chief among those laws and regulations are the Arms Export Control Act (AECA) (22 U.S.C. § 2778) and the International Traffic in Arms Regulations (ITAR) (22 C.F.R. §§ 120-130). Under the AECA, the purpose of which is stated to be the furtherance of world peace and the security and foreign policy of the United States, "the President [of the United States] is authorized to designate those items which shall be considered as defense articles and defense services for the purposes of this section and to promulgate regulations for the import and export of such articles and services. The items so designated shall constitute the United States Munitions List." (22 U.S.C. § 2778(a)(1).) The Munitions List is "a categorical list of 'defense articles' that cannot be exported without first obtaining a license from the Department of State." (*United States v. Hsu* (4th Cir. 2004) 364 F.3d 192, 194.) The Munitions List is contained in the ITAR.

The ITAR requires any company intending to export defense articles (those items on the Munitions List) or defense services to first obtain permission from the Directorate of Defense Trade Controls (DDTC) at the Department of State. (22 U.S.C. §§ 2778-2780; 22 C.F.R. § 123.1.) For the sale of certain high-value defense articles, notice must be given to the United States Congress, and Congress may enact a resolution to prohibit the export. (22 U.S.C. § 2776(c)(1); 22 C.F.R. § 123.15(a).) Applications are reviewed on a case-by-case basis, proceed under a "presumption of denial," and may take many months to reach disposition.⁸ It is recognized that the application process and delays caused by it result in commercial companies losing the opportunity to respond to a bid; thus, "[e]ntire international markets are denied to U.S. companies"⁹

"Export" is defined broadly to include sending or taking a defense article out of the United States; transferring registration, control or ownership to a foreign person; disclosing or transferring in the United States any defense article to a foreign government; disclosing or transferring technical data to a foreign person, whether in the United States or abroad; and performing a defense service on behalf of, or for the benefit of, a foreign person, whether in the

⁶ Cal. U. Com. Code, § 2106, subd. (1).

⁷ SpaceX's contracts are facially drafted as a fabrication and launch services agreement that do not state that title to the fabricated space transportation equipment passes to the customer.

⁸ Joint Publication of the Department of Commerce and the Federal Aviation Administration, Introduction to U.S. Export Controls for the Commercial Space Industry (October 2008) p. 4. See also Air Force Research Labs, Defense Industrial Base Assessment: U.S. Space Industry (August 2007) p. 42.

⁹ Hearing before House Committee on Science and Technology, Impacts of US Export Control Policies on Science and Technology Activities and Competitiveness, 111th Cong., 1st Sess., pp. 5, 8 (2009).

United States or abroad. (22 C.F.R. § 120.17.) ITAR specifically states, however, that "[a] launch vehicle or payload shall not, by reason of the launching of such vehicle, be considered an export for purposes of this subchapter."¹⁰ (22 C.F.R. § 120.17(a)(6).)

Equipment of the type fabricated by SpaceX is listed in Categories IV and XV of the Munitions List and, as such, constitutes "defense articles." (See 22 C.F.R. §§ 120.6, 121.1.) ITAR not only includes the space transportation equipment itself as a defense article, but includes technical data, which is defined as: "Information . . . which is required for the design, development, production, manufacture, assembly, operation, repair, testing, maintenance or modification of defense articles. This includes information in the form of blueprints, drawings, photographs, plans, instructions or documentation." (22 C.F.R. § 121.10(a).) Although SpaceX's Equipment and related technical data are clearly defense articles pursuant to ITAR, because SpaceX has structured its business as the provision of fabrication and launch services, it appears SpaceX receives special treatment under the ITAR regime in regards to the export of certain of its products.¹¹

Therefore, it is clear that the governing federal statutes and regulations heavily regulate the space flight industry, creating a unique market in which the technical sale of goods is constrained to make the transfer of title of space flight equipment extremely difficult, if not practically impossible. In our view, sections 219 and 129 and Rule 133 could not have contemplated this unique set of circumstances. Sections 219 and 129 were enacted in the late 1960's, contemplating an open and free market, and not a market with barriers to sale placed by the federal government due to national security and foreign policy concerns.¹² In our view, when SpaceX's business is viewed in light of the heavily regulated market in which it operates, the required relinquishment of control of its Equipment by SpaceX to federal authority at launch should qualify as a "sale" within the meaning of the business inventory exemption.

While SpaceX contracts do not provide for the passage of title of its Equipment to its customers, it is clear that SpaceX cedes ultimate control, and, effectively, the rights of ownership, of the Equipment at the point of launch. In the context of goods that are not "sold" in the typical sense, courts have looked at who had control over the product in determining whether the goods qualified for the business inventory exemption.¹³ For example, in *Westinghouse Beverage Group v. County of San Diego* (1988) 203 Cal.App.3d 1442, the Court considered syrup and CO2 containers.¹⁴ It held that such containers were taxable since the seller retained control over the containers for its own use on the lien date even though the containers were in the physical possession of its wholesale customers. The Court contrasted this situation with

¹⁰ It appears this provision was added to ITAR in 1984 with the enactment of the Commercial Space Launch Act, which was designed to encourage the private sector in commercial space endeavors. (49 Fed. Reg. 47682 (Dec. 6, 1984), Presidential Statement on Signing the Commercial Space Launch Act (October 30, 1984).)

¹¹ Given 22 C.F.R. § 120.17(a)(6), it appears that SpaceX's Equipment is not subject to ITAR. It appears, however, that SpaceX must comply with the AECA and ITAR for any "defense services" it provides, as well as for the launching of any vehicles that do not meet the export exception.

¹² Part of the rationale for the need for the business inventory exemption was to make the personal property tax more equitable between firms that could avoid the tax on inventories by easily moving property outside of the state and firms that could not so easily move property. It was argued that the open economy discouraged firms from locating in California. (See Assem. Interim Com. on Rev. and Tax., Taxation of Property in California, A Major Tax Study, Part 5 (December 1964) p. 150.)

¹³ We also note that the transfer of control of the space transportation equipment would constitute a sale of tangible personal property for sales and use tax purposes. (See Rev. & Tax. Code, § 6006, subd. (a).) However, space flight property transactions are exempt from sales and use tax pursuant to section 6380.

¹⁴ See also Letter to Assessor 83/59.

returnable bottles in which completed soft drink beverages 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, 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 ultimate control, albeit indirect, of where the goods would be delivered.

SpaceX's contracts demonstrate that this is the case for its Equipment. For example, SpaceX has full custody of the space transportation equipment only until launch.¹⁵ Additionally, pursuant to the sample contracts you provided for our review, SpaceX is responsible and liable for any damage to the space transportation equipment from fabrication through delivery to the launch site.¹⁶ Upon launch, SpaceX relinquishes ultimate control over the space transportation equipment, and its obligations are essentially complete upon launch initiation, regardless of the outcome.¹⁷ The orbital parameters and "injection" requirements and coordinates for payload delivery are set by the customer prior to launch and SpaceX has no ability to change those coordinates.¹⁸ Upon launch, pursuant to federal law, control must be given to the Range Safety Officer, who, in his or her sole discretion, makes the judgment as to whether to abort the mission and destroy the Equipment with its payload.¹⁹ If the Range Safety Officer aborts the mission and the Equipment is destroyed, the customer has no recourse against SpaceX, unless a reflight was expressly bargained for as part of the subject contract.²⁰ If the launch proceeds, after the payload is delivered, the Equipment is abandoned and either burns up in space or becomes space junk.²¹

In addition to the fact that it relinquishes control over the Equipment upon launch, SpaceX meets several factors specifically cited by the court in *Amdahl* in determining whether goods qualify for the inventory exemption. First, SpaceX accounts for its Equipment as inventory for accounting purposes. (See *Amdahl, supra*, at p. 616-617 [method of accounting is probative evidence of whether spare parts were inventory].) Further, SpaceX advertises and openly offers its space transportation equipment fabrication and launch services. (See *Amdahl, supra*, at p. 617 [scant evidence that spare parts were openly offered for sale weighed against the spare parts being classified as inventory].) Finally, SpaceX's contracts call for consideration that reflects the fabrication of the space transportation equipment as well as its launch services. (See *Amdahl, supra*, at p. 615 [lack of consideration by customers for transfer of spare parts weighed against the spare parts being classified as inventory].)

In sum, it is clear that SpaceX operates in a unique industry with heavy restrictions on the transfer of title to its Equipment due to national security and foreign policy concerns, which, in turn, heavily restricts the Equipment's marketability. Within this context, because SpaceX's ceding of control of its Equipment to federal authority in exchange for consideration provided by

¹⁵ "Contract for the Fabrication of Two Falcon 9 (F9) Launch Vehicles and Corresponding Launch Services" (Fabrication Contract), § 21.

¹⁶ Fabrication Contract, § 33.1.b.

¹⁷ Fabrication Contract, § 2.29.

¹⁸ See, for example, Fabrication Contract, Annex B.

¹⁹ The Range Safety Officer is the official at the launch site designated by the Launch Range Authority to terminate a launch if deemed necessary to prevent bodily injury or property loss or damage. Fabrication Contract, §§ 2.23, 26.

²⁰ Fabrication Contract, §§ 20, 33.1.d.

²¹ As discussed previously, for missions where a Capsule returns to earth, the Capsule is not reusable. It is our understanding that SpaceX contemplates that, subject to federal approval, its Capsules may eventually become reusable. To the extent any Capsule (or other Equipment) over which control is relinquished at launch is subsequently regained and reused, such Equipment may not qualify for the business inventory exemption as discussed herein. Such a factual scenario is not addressed by this opinion.

its customers is sufficient to constitute a "sale" for business inventory purposes and because SpaceX meets a number of criteria weighed by courts in determining whether the business inventory exemption applies, in our view, SpaceX's Equipment qualifies for the business inventory exemption.

The views expressed in this letter are only advisory in nature; they represent the analysis of the legal staff of the Board based on present law and the facts set forth herein, and are not binding on any person or public entity.

Sincerely,

/s/ Richard Moon

Richard Moon
Tax Counsel IV

RM:yg

J:/Prop/Prec/Genexemp/2013/13-253.doc

cc: Ms.
Chief Deputy Assessor
Los Angeles County Assessor's Office

Ms.
Director
Los Angeles County Assessor's Office

Mr. David Gau MIC:63
Mr. Dean Kinnee MIC:64
Mr. Todd Gilman MIC:70