



STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION

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September 25, 2015

To Interested Parties:

Notice of Proposed Regulatory Action

The State Board of Equalization Proposes to Adopt

Amendments to California Code of Regulations,

Title 18,

Section 1525.4, Manufacturing and Research & Development Equipment

NOTICE IS HEREBY GIVEN that the State Board of Equalization (Board), pursuant to the authority vested in it by Revenue and Taxation Code (RTC) section 7051, proposes to adopt amendments to California Code of Regulations, title 18, section (Regulation or Reg.) 1525.4, *Manufacturing and Research & Development Equipment*. The proposed amendments further implement, interpret, and makes specific the “useful life” provisions used in RTC section 6377.1, which provides a partial sales and use tax exemption for the sale and storage, use, or other consumption of equipment used primarily in manufacturing, and research and development, by adding clarifying provisions to the regulation expressly permitting taxpayers to substantiate the useful life of otherwise qualified tangible personal property using a warranty, service contract, or industry practice.

PUBLIC HEARING

The Board will conduct a meeting in Room 207 at 5901 Green Valley Circle, Culver City, California, on November 17-19, 2015. The Board will provide notice of the meeting to any person who requests that notice in writing and make the notice, including the specific agenda for the meeting, available on the Board’s Website at www.boe.ca.gov at least 10 days in advance of the meeting.

A public hearing regarding the proposed regulatory action will be held at 9:30 a.m. or as soon thereafter as the matter may be heard on November 17, 18 or 19, 2015. At the hearing, any

interested person may present or submit oral or written statements, arguments, or contentions regarding the adoption of the proposed amendments to Regulation 1525.4.

AUTHORITY

RTC section 7051

REFERENCE

RTC section 6377.1

INFORMATIVE DIGEST/POLICY STATEMENT OVERVIEW PURSUANT TO GOVERNMENT CODE SECTION 11346.5, SUBDIVISION (a)(3)

Summary of Existing Laws and Regulations

As a general matter, California's Sales and Use Tax Law (Rev. & Tax. Code (RTC), § 6001 et seq.) imposes sales tax on retailers, and the tax is measured by a retailer's gross receipts from the retail sale of tangible personal property in California, unless an exemption or exclusion applies. (RTC, §§ 6012, 6051.) Although sales tax is imposed on retailers, retailers may collect sales tax reimbursement from their customers if their contracts of sale so provide. (Civ. Code, § 1656.1; Reg. 1700.)

When sales tax does not apply, California use tax generally applies to the use of tangible personal property purchased from a retailer for storage, use or other consumption in California. (RTC, § 6201.) Unless an exemption or exclusion applies, the use tax is measured by the sales price of tangible personal property and the person actually storing, using, or otherwise consuming the tangible personal property is liable for the tax. (RTC, §§ 6011, 6201, 6202, 6401; Cal. Code Regs., tit. 18, § 1685.) However, every retailer "engaged in business" in California that makes sales subject to California use tax is required to collect the use tax from its customers and remit it to the State Board of Equalization (Board), and such retailers are liable for California use tax that they fail to collect from their customers and remit to the Board. (RTC, §§ 6202, 6203; Regs. 1684, 1686.)

The measure of tax is generally the same regardless of whether the applicable tax is a sales tax imposed on the retailer, or a use tax imposed on the purchaser. (See RTC, §§ 6011, 6012.) The current statewide sales and use tax rate is 7.50 percent, the composition of the 7.50 percent rate is discussed in the initial statement of reasons, and the combined tax rate is higher than 7.50 percent in cities and counties that impose additional district transactions (sales) and use taxes in conformity with the Transactions and Use Tax Law (RTC, § 7251 et seq.).

RTC section 6377.1 was enacted by Assembly Bill No. (AB) 93 (Stats. 2013, ch. 69, effective July 11, 2013), and amended by Senate Bill No. (SB) 90 (Stats. 2013, ch. 70, effective July 11, 2013). RTC section 6377.1, subdivision (a), provides a partial exemption from sales and use tax

on certain sales and purchase made on and after July 1, 2014, and before July 1, 2022. The exemption provided by RTC section 6377.1, subdivision (a), is referred to as a partial exemption because RTC section 6377.1, subdivision (d), specifies that the exemption does not apply to any local sales and use taxes levied pursuant to the Bradley-Burns Uniform Local Sales and Use Tax Law or district transactions and use taxes levied pursuant to the Transactions and Use Tax Law; and does not apply to any sales and use taxes levied pursuant to RTC sections 6051.2, 6051.5, 6201.2, and 6201.5, any sales and use taxes levied pursuant to section 35 of article XIII of the California Constitution, and any sales and use taxes levied pursuant to RTC sections 6051 and 6201 that are required to be deposited in the Local Revenue Fund 2011 by RTC sections 6051.15 and 6201.15.

RTC section 6377.1, subdivision (a), provides that the partial exemption provided by RTC section 6377.1 applies to: (1) qualified tangible personal property purchased by a qualified person to be used primarily in any stage of the manufacturing, processing, refining, fabricating, or recycling of tangible personal property, including packaging if required; (2) qualified tangible personal property purchased for use by a qualified person to be used primarily in research and development; (3) qualified tangible personal property purchased for use by a qualified person to be used primarily to maintain, repair, measure, or test any qualified tangible personal property described under (1) or (2) above; and (4) qualified tangible personal property purchased for use by a contractor purchasing that property for use in the performance of a construction contract for a qualified person that will use that property for statutorily specified purposes.

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

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

- (i) Machinery and equipment, including component parts and contrivances such as belts, shafts, moving parts, and operating structures.
- (ii) Equipment or devices used or required to operate, control, regulate, or maintain the machinery, including, but not limited to, computers, data-processing equipment, and computer software, together with all repair and replacement parts with a useful life of one or more years therefor, whether purchased separately or in conjunction with a complete machine and regardless of whether the machine or component parts are assembled by the qualified person or another party.
- (iii) Tangible personal property used in pollution control that meets standards established by this state or any local or regional governmental agency within this state.
- (iv) Special purpose buildings and foundations used as an integral part of the manufacturing, processing, refining, fabricating, or recycling process, or that constitute a research or storage facility used during those processes. Buildings used solely for warehousing purposes after completion of those processes are not included.

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

- (i) Consumables with a useful life of less than one year.
- (ii) Furniture, inventory, and equipment used in the extraction process, or equipment used to store finished products that have completed the manufacturing, processing, refining, fabricating, or recycling process.
- (iii) Tangible personal property used primarily in administration, general management, or marketing.

As relevant here, RTC section 6377.1, subdivision (b)(10), defines the term “useful life,” which is used in the definition of “qualified tangible personal property.” Subdivision (b)(10) provides that “‘Useful life’ for tangible personal property that is treated as having a useful life of one or more years for state income or franchise tax purposes shall be deemed to have a useful life of one or more years for purposes of this section. ‘Useful life’ for tangible personal property that is treated as having a useful life of less than one year for state income or franchise tax purposes shall be deemed to have a useful life of less than one year for purposes of this section” (hereafter also referred to as the “deemed” provisions of RTC section 6377.1).

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

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

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

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

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

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

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

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

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

Rulemaking Petition

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

Current statutory language is unclear, and provides inconsistent guidance with regard to how taxpayers may substantiate, and how the BOE may verify, that qualified manufacturing and R&D equipment has a useful life of one or more years. The current provisions may be interpreted to inadvertently disallow an exemption for qualified equipment unless it is capitalized on the state income/franchise tax returns. This results in:

- **Disparate treatment of taxpayers** - Taxpayers purchasing the same piece of equipment for the same purpose may receive different tax treatment. For example:

Taxpayer A purchases qualifying equipment for use in manufacturing/R&D, and opts to report the expenditure as a capital expense over the next couple of years on his income tax returns. Taxpayer A is eligible for the exemption.

Taxpayer B purchases the identical equipment for use in manufacturing/R&D, but does not have the resources/staff to prepare/file/annually track capital assets, so he reports the expenditure as a deduction on his tax returns. Taxpayer B may **NOT** be eligible for the exemption.

- **Disallowance of qualified equipment** - Manufacturing and R&D equipment that meets ALL other statutory requirements, including qualifying uses by qualifying manufacturers and R&D companies engaged in qualifying activities for qualifying purposes, etc. may be disallowed the exemption because of how the taxpayer reports the cost of the equipment on his/her income tax returns.
- **Failure to adhere to legislative intent** - Some businesses, particularly smaller businesses, do not capitalize equipment due to unpredictable annual gross receipts and lack of economies of scale. An interpretation that limits qualification to capitalized equipment would disqualify many of the small businesses and equipment component parts that the Legislature intended be eligible for the exemption.

To remedy these situations, CalTax petitions the BOE to add clarifying language (attachment) to allow eligible taxpayers purchasing qualified equipment to substantiate qualification under the “useful life” criteria by reference to either a warranty, a maintenance agreement, or industry replacement standard of a duration of one or more years. The existing substantiation approach (by reference to treatment on the state’s income/franchise tax returns) would be retained as one of the substantiation methods.

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

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

(B) For purposes of applying subdivision (b)(13)(A), tangible personal property that meets any one of the following criteria shall be deemed as having a useful life of one or more years for state income or franchise tax purposes:

1. Tangible [personal] property included under a warranty by the manufacturer or other third party to last one or more years shall be treated as having a useful life of one or more years for purposes of this regulation.

2. Tangible personal property that is included under a maintenance contract lasting one or more years shall be treated as having a useful life of one or more years for purposes of this regulation.

3. Tangible personal property that is normally replaced at intervals of one or more years, as established by industry or business practices or based on the actual experience of the person claiming the exemption, or is expected at the time of purchase to last one or more years, as established by industry or business practices or based on the actual experience of the person claiming the exemption, shall be treated as having a useful life of one or more years for purposes of this regulation.

(C) Examples: Useful life is determined by answering the following questions for tangible personal property:

Example 1. Is the tangible personal property capitalized for state tax purposes or accounting purposes?

- If the answer is “yes,” it meets the useful life requirement.

- If the answer is “no,” go to the next question.

Example 2. Is the tangible personal property warranted by the manufacturer or other third party to last one year or more?

- If the answer is “yes,” it meets the useful life requirement.

- If the answer is “no,” go to the next question.

Example 3. Is the tangible personal property normally replaced at intervals of one year or more, as established by industry or business practice? (This is commonly based on the actual experience of the person claiming the exemption.)

- If the answer is “yes,” it meets the useful life requirement.

- If the answer is “no,” go to the next question.

Example 4. Is the tangible personal property expected at the time of purchase to last one year or more, as established by industry or business practice? (This is commonly based on the actual experience of the person claiming the exemption.)

- If the answer is “yes,” it meets the useful life requirement.

- If the answer is “no,” it does not meet the useful life requirement.

Chief Counsel Memorandum

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

The Chief Counsel Memorandum explained that staff “recognizes that [RTC] section 6377.1 may be interpreted by some as ambiguous and potentially inconsistent in its drafting. Subdivision (b)(7)(A)(i) of RTC section 6377.1 states that ‘qualified tangible personal property’ includes component parts and contrivances such as belts, shafts, moving parts, and operating structures. However, subdivision (b)(10) of RTC section 6377.1 states that [the] ‘useful life’ for tangible personal property that is treated as having a useful life of less than one year for state income or franchise tax purposes shall be deemed to have a useful life of less than one year for the purposes of this section. As pointed out by CalTax, one taxpayer may report the purchase of a belt [with a useful life of more than one year] as a capital asset, but another taxpayer, perhaps having fewer resources, may report an identical belt as an expenditure as a deduction on an income or franchise tax return rather than a capital asset.”

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

The Chief Counsel Memorandum also advised the Board, that “[i]f the Board agrees that, in light of the entire statutory scheme, the Legislature intended to make the partial exemption available in all circumstances where a qualified person can establish that otherwise qualified tangible personal property has a useful life of one year or more, [then,] subject to approval by the Office of Administrative Law [(OAL)], CalTax’s requested amendments will address the issues raised by CalTax and effectuate such legislative intent.”

August 25, 2015, Board Meeting

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

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

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

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

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

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

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

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

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

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

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

NO MANDATE ON LOCAL AGENCIES OR SCHOOL DISTRICTS

The Board has determined that the adoption of the proposed amendments to Regulation 1525.4 will not impose a mandate on local agencies or school districts, including a mandate that requires state reimbursement pursuant to title 2, division 4, part 7 (commencing with section 17500) of the Government Code.

NO COST OR SAVINGS TO ANY STATE AGENCY, LOCAL AGENCY, OR SCHOOL DISTRICT

The Board has determined that the adoption of the proposed amendments to Regulation 1525.4 will result in no direct or indirect cost or savings to any state agency and will result in no cost or savings in federal funding to the State of California. The Board has also determined that the adoption of the proposed amendments to Regulation 1525.4 will result in no direct or indirect cost to any local agency or school district that is required to be reimbursed under title 2, division 4, part 7 (commencing with section 17500) of the Government Code, and will result in no other non-discretionary cost or savings imposed on local agencies.

NO SIGNIFICANT STATEWIDE ADVERSE ECONOMIC IMPACT DIRECTLY AFFECTING BUSINESS

The Board has made an initial determination that adoption of the proposed amendments to Regulation 1525.4 will not have a significant, statewide adverse economic impact directly affecting business, including the ability of California businesses to compete with businesses in other states.

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

NO KNOWN COST IMPACTS TO PRIVATE PERSONS OR BUSINESSES

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

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

The Board has determined that the proposed amendments to Regulation 1525.4 are not a major regulation, as defined in Government Code section 11342.548 and California Code of Regulations, title 1, section 2000. Therefore, the Board has prepared the economic impact assessment required by Government Code section 11346.3, subdivision (b)(1), and included it in the initial statement of reasons. The Board has determined that the adoption of the proposed amendments to Regulation 1525.4 will neither create nor eliminate jobs in the State of California nor result in the elimination of existing businesses nor create or expand business in the State of California. Furthermore, the Board has determined that the adoption of the proposed amendments to Regulation 1525.4 will not affect the benefits of Regulation 1525.4 to the health and welfare of California residents, worker safety, or the state's environment.

NO SIGNIFICANT EFFECT ON HOUSING COSTS

The adoption of the proposed amendments to Regulation 1525.4 will not have a significant effect on housing costs.

STATEMENT REGARDING ALTERNATIVES

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

CONTACT PERSONS

Questions regarding the substance of the proposed amendments should be directed to Bradley M. Heller, Tax Counsel IV, by telephone at (916) 323-3091, by e-mail at Bradley.Heller@boe.ca.gov, or by mail at State Board of Equalization, Attn: Bradley Heller, MIC:82, 450 N Street, P.O. Box 942879, Sacramento, CA 94279-0082.

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

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

WRITTEN COMMENT PERIOD

The written comment period ends at 9:30 a.m. on November 17, 2015, or as soon thereafter as the Board begins the public hearing regarding the proposed amendments to Regulation 1525.4 during the November 17-19, 2015, Board meeting. Written comments received by Mr. Rick Bennion at the postal address, email address, or fax number provided above, prior to the close of the written comment period, will be presented to the Board and the Board will consider the statements, arguments, or contentions contained in those written comments before the Board decides whether to adopt the proposed amendments to Regulation 1525.4. The Board will only consider written comments received by that time.

AVAILABILITY OF INITIAL STATEMENT OF REASONS AND TEXT OF PROPOSED REGULATION

The Board has prepared a copy of the text of the proposed amendments to Regulation 1525.4 and the additions to the regulation are underlined in the text. The Board has also prepared an initial statement of reasons for the adoption of the proposed amendments to Regulation 1525.4, which includes the economic impact assessment required by Government Code section 11346.3, subdivision (b)(1). These documents and all the information on which the proposed amendments are based are available to the public upon request.

The rulemaking file is available for public inspection at 450 N Street, Sacramento, California. The express terms of the proposed amendments and the initial statement of reasons are also available on the Board's Website at www.boe.ca.gov.

SUBSTANTIALLY RELATED CHANGES PURSUANT TO GOVERNMENT CODE SECTION 11346.8

The Board may adopt the proposed amendments to Regulation 1525.4 with changes that are nonsubstantial or solely grammatical in nature, or sufficiently related to the original proposed text that the public was adequately placed on notice that the changes could result from the originally proposed regulatory action. If a sufficiently related change is made, the Board will make the full text of the proposed amendments, with the change clearly indicated, available to the public for at least 15 days before adoption. The text of the proposed amendments, with the change clearly indicated, will be mailed to those interested parties who commented on the original proposed amendments orally or in writing or who asked to be informed of such changes. The text of the proposed amendments, with the change clearly indicated, will also be available to the public from Mr. Bennion. The Board will consider written comments regarding the

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

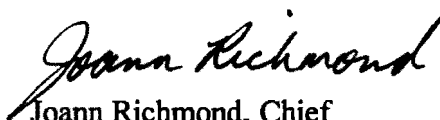
EFFECTIVE DATE

The Board is proposing to adopt amendments to Regulation 1525.4 to further implement, interpret, and make specific the partial exemption from sales and use tax provided by RTC section 6377.1. The partial exemption became effective on July 1, 2014, and is not being utilized as anticipated and intended by the Legislature, which may be due to the ambiguity in RTC section 6377.1 that the amendments are intended to clarify. Also, once the proposed amendments are effective, the clarification will have a retroactive effect pursuant to RTC section 7051. Therefore, the Board has determined that there is good cause to request an early effective date for the proposed clarifying amendments to Regulation 1525.4 in order to help ensure that the partial exemption begins to be utilized as originally anticipated and intended by the Legislature, as soon as possible, and the Board may request an early effective date for the proposed amendments to Regulation 1525.4, pursuant to Government Code section 11343.4, subdivision (b)(3).

AVAILABILITY OF FINAL STATEMENT OF REASONS

If the Board adopts the proposed amendments to Regulation 1525.4, the Board will prepare a final statement of reasons, which will be made available for inspection at 450 N Street, Sacramento, California, and available on the Board's Website at www.boe.ca.gov.

Sincerely,


Joann Richmond, Chief
Board Proceedings Division


JR:reb

STATE BOARD OF EQUALIZATION



BOARD APPROVED

At the November 17, 2015 Board Meeting


Joann Richmond, Chief
Board Proceedings Division



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

SPECIFIC PURPOSE, PROBLEM INTENDED TO BE ADDRESSED, NECESSITY,
AND ANTICIPATED BENEFITS

Current Law

As a general matter, California's Sales and Use Tax Law (Rev. & Tax. Code (RTC), § 6001 et. seq.) imposes sales tax on retailers, and the tax is measured by a retailer's gross receipts from the retail sale of tangible personal property in California, unless an exemption or exclusion applies. (RTC, §§ 6012, 6051.) Although sales tax is imposed on retailers, retailers may collect sales tax reimbursement from their customers if their contracts of sale so provide. (Civ. Code, § 1656.1; Cal. Code Regs., tit. 18, § (Regulation or Reg. 1700.)

When sales tax does not apply, California use tax generally applies to the use of tangible personal property purchased from a retailer for storage, use or other consumption in California. (RTC, § 6201.) Unless an exemption or exclusion applies, the use tax is measured by the sales price of tangible personal property and the person actually storing, using, or otherwise consuming the tangible personal property is liable for the tax. (RTC, §§ 6011, 6201, 6202, 6401; Cal. Code Regs., tit. 18, § 1685.) However, every retailer "engaged in business" in California that makes sales subject to California use tax is required to collect the use tax from its customers and remit it to the State Board of Equalization (Board), and such retailers are liable for California use tax that they fail to collect from their customers and remit to the Board. (RTC, §§ 6202, 6203; Regs. 1684, 1686.)

The measure of tax is generally the same regardless of whether the applicable tax is a sales tax imposed on the retailer, or a use tax imposed on the purchaser. (See RTC, §§ 6011, 6012.) The current statewide sales and use tax rate is 7.50 percent, although the combined tax rate is higher in cities and counties that impose additional district transactions (sales) and use taxes in conformity with the Transactions and Use Tax Law (RTC, § 7251 et seq.). The 7.50 percent rate is comprised of:

- The .50 percent rate of the sales and use taxes imposed and required to be deposited in the state's Local Public Safety Fund by section 35 of article XIII of the California Constitution;
- The .25 percent rate of the sales and use taxes imposed and required to be deposited in the state's Education Protection Account by section 36 of article XIII of the California Constitution;
- The 3.6875 percent rate of the sales and use taxes imposed by RTC sections 6051 and 6201 that are deposited in the state's general fund;

- The 0.50 percent rate of the sales and use taxes imposed and required to be deposited in the state’s Local Revenue Fund by RTC sections 6051.2 and 6201.2;
- The 0.25 percent rate of the sales and use taxes imposed by RTC sections 6051.3 and 6201.3 that are deposited in the state’s general fund;
- The 0.25 percent rate of the sales and use taxes imposed and required to be deposited in the state’s Fiscal Recovery Fund by RTC sections 6051.5 and 6201.5;
- The 1.0625 percent rate of the sales and use taxes imposed by RTC sections 6051 and 6201 that are required to be deposited in the state’s Local Revenue Fund 2011 by RTC sections 6051.15 and 6201.15; and
- The 1.00 percent rate specified by RTC section 7203.1 for local sales and use taxes imposed under the Bradley-Burns Uniform Local Sales and Use Tax Law (RTC, § 7200 et seq.).

RTC section 6377.1 was enacted by Assembly Bill No. (AB) 93 (Stats. 2013, ch. 69, effective July 11, 2013), and amended by Senate Bill No. (SB) 90 (Stats. 2013, ch. 70, effective July 11, 2013). RTC section 6377.1, subdivision (a), provides a partial exemption from sales and use tax on certain sales and purchase made on and after July 1, 2014, and before July 1, 2022. The exemption provided by RTC section 6377.1, subdivision (a), is referred to as a partial exemption because RTC section 6377.1, subdivision (d), specifies that the exemption does not apply to any local sales and use taxes levied pursuant to the Bradley-Burns Uniform Local Sales and Use Tax Law or district transactions and use taxes levied pursuant to the Transactions and Use Tax Law; and does not apply to any sales and use taxes levied pursuant to RTC sections 6051.2, 6051.5, 6201.2, and 6201.5, any sales and use taxes levied pursuant to section 35 of article XIII of the California Constitution, and any sales and use taxes levied pursuant to RTC sections 6051 and 6201 that are required to be deposited in the Local Revenue Fund 2011 by RTC sections 6051.15 and 6201.15.

RTC section 6377.1, subdivision (a), provides that the partial exemption provided by RTC section 6377.1 applies to: (1) qualified tangible personal property purchased by a qualified person to be used primarily in any stage of the manufacturing, processing, refining, fabricating, or recycling of tangible personal property, including packaging if required; (2) qualified tangible personal property purchased for use by a qualified person to be used primarily in research and development; (3) qualified tangible personal property purchased for use by a qualified person to be used primarily to maintain, repair, measure, or test any qualified tangible personal property described under (1) or (2) above; and (4) qualified tangible personal property purchased for use by a contractor purchasing that property for use in the performance of a construction contract for a qualified person that will use that property for statutorily specified purposes.

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

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

- (i) Machinery and equipment, including component parts and contrivances such as belts, shafts, moving parts, and operating structures.
 - (ii) Equipment or devices used or required to operate, control, regulate, or maintain the machinery, including, but not limited to, computers, data-processing equipment, and computer software, together with all repair and replacement parts with a useful life of one or more years therefor, whether purchased separately or in conjunction with a complete machine and regardless of whether the machine or component parts are assembled by the qualified person or another party.
 - (iii) Tangible personal property used in pollution control that meets standards established by this state or any local or regional governmental agency within this state.
 - (iv) Special purpose buildings and foundations used as an integral part of the manufacturing, processing, refining, fabricating, or recycling process, or that constitute a research or storage facility used during those processes. Buildings used solely for warehousing purposes after completion of those processes are not included.
- (B) “Qualified tangible personal property” shall not include any of the following:
- (i) Consumables with a useful life of less than one year.
 - (ii) Furniture, inventory, and equipment used in the extraction process, or equipment used to store finished products that have completed the manufacturing, processing, refining, fabricating, or recycling process.
 - (iii) Tangible personal property used primarily in administration, general management, or marketing.

As relevant here, RTC section 6377.1, subdivision (b)(10), defines the term “useful life,” which is used in the definition of “qualified tangible personal property.” Subdivision (b)(10) provides that “‘Useful life’ for tangible personal property that is treated as having a useful life of one or more years for state income or franchise tax purposes shall be deemed to have a useful life of one or more years for purposes of this section. ‘Useful life’ for tangible personal property that is treated as having a useful life of less than one year for state income or franchise tax purposes shall be deemed to have a useful life of less than one year for purposes of this section” (hereafter also referred to as the “deemed” provisions of RTC section 6377.1).

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

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

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

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

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

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

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

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

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

Proposed Amendments

Rulemaking Petition

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

Current statutory language is unclear, and provides inconsistent guidance with regard to how taxpayers may substantiate, and how the BOE may verify, that qualified manufacturing and R&D equipment has a useful life of one or more years. The current provisions may be interpreted to inadvertently disallow an exemption for qualified equipment unless it is capitalized on the state income/franchise tax returns. This results in:

- **Disparate treatment of taxpayers** - Taxpayers purchasing the same piece of equipment for the same purpose may receive different tax treatment. For example:

Taxpayer A purchases qualifying equipment for use in manufacturing/R&D, and opts to report the expenditure as a capital expense over the next couple of years on his income tax returns. Taxpayer A is eligible for the exemption.

Taxpayer B purchases the identical equipment for use in manufacturing/R&D, but does not have the resources/staff to prepare/file/annually track capital assets, so he reports the expenditure as a deduction on his tax returns. Taxpayer B may **NOT** be eligible for the exemption.

- **Disallowance of qualified equipment** - Manufacturing and R&D equipment that meets ALL other statutory requirements, including qualifying uses by qualifying manufacturers and R&D companies engaged in qualifying activities for qualifying purposes, etc. may

be disallowed the exemption because of how the taxpayer reports the cost of the equipment on his/her income tax returns.

- **Failure to adhere to legislative intent** - Some businesses, particularly smaller businesses, do not capitalize equipment due to unpredictable annual gross receipts and lack of economies of scale. An interpretation that limits qualification to capitalized equipment would disqualify many of the small businesses and equipment component parts that the Legislature intended be eligible for the exemption.

To remedy these situations, CalTax petitions the BOE to add clarifying language (attachment) to allow eligible taxpayers purchasing qualified equipment to substantiate qualification under the “useful life” criteria by reference to either a warranty, a maintenance agreement, or industry replacement standard of a duration of one or more years. The existing substantiation approach (by reference to treatment on the state’s income/franchise tax returns) would be retained as one of the substantiation methods.

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

(13)(A)¹ “Useful life.” Tangible personal property that the qualified person treats as having a useful life of one or more years for state income or franchise tax purposes shall be deemed to have a useful life of one or more years for purposes of this regulation. Tangible personal property that the qualified person treats as having a useful life of less than one year for state income or franchise tax purposes shall be deemed to have a useful life of less than one year for purposes of this regulation.

(B) For purposes of applying subdivision (b)(13)(A), tangible personal property that meets any one of the following criteria shall be deemed as having a useful life of one or more years for state income or franchise tax purposes:

1. Tangible personal² property included under a warranty by the manufacturer or other third party to last one or more years shall be treated as having a useful life of one or more years for purposes of this regulation.

2. Tangible personal property that is included under a maintenance contract lasting one or more years shall be treated as having a useful life of one or more years for purposes of this regulation.

¹ The attachment illustrated the requested amendments in italics, and they are shown here in underline.

² The attachment inadvertently omitted the word “personal” from the text of proposed subdivision (b)(13)(B)1.

3. Tangible personal property that is normally replaced at intervals of one or more years, as established by industry or business practices or based on the actual experience of the person claiming the exemption, or is expected at the time of purchase to last one or more years, as established by industry or business practices or based on the actual experience of the person claiming the exemption, shall be treated as having a useful life of one or more years for purposes of this regulation.

(C) Examples: Useful life is determined by answering the following questions for tangible personal property:

Example 1. Is the tangible personal property capitalized for state tax purposes or accounting purposes?

- If the answer is “yes,” it meets the useful life requirement.
- If the answer is “no,” go to the next question.

Example 2. Is the tangible personal property warranted by the manufacturer or other third party to last one year or more?

- If the answer is “yes,” it meets the useful life requirement.
- If the answer is “no,” go to the next question.

Example 3. Is the tangible personal property normally replaced at intervals of one year or more, as established by industry or business practice? (This is commonly based on the actual experience of the person claiming the exemption.)

- If the answer is “yes,” it meets the useful life requirement.
- If the answer is “no,” go to the next question.

Example 4. Is the tangible personal property expected at the time of purchase to last one year or more, as established by industry or business practice? (This is commonly based on the actual experience of the person claiming the exemption.)

- If the answer is “yes,” it meets the useful life requirement.
- If the answer is “no,” it does not meet the useful life requirement.

Chief Counsel Memorandum

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

The Chief Counsel Memorandum explained that staff “recognizes that [RTC] section 6377.1 may be interpreted by some as ambiguous and potentially inconsistent in its drafting. Subdivision (b)(7)(A)(i) of RTC section 6377.1 states that ‘qualified tangible personal property’ includes component parts and contrivances such as belts, shafts,

moving parts, and operating structures. However, subdivision (b)(10) of RTC section 6377.1 states that [the] ‘useful life’ for tangible personal property that is treated as having a useful life of less than one year for state income or franchise tax purposes shall be deemed to have a useful life of less than one year for the purposes of this section. As pointed out by CalTax, one taxpayer may report the purchase of a belt [with a useful life of more than one year] as a capital asset, but another taxpayer, perhaps having fewer resources, may report an identical belt as an expenditure as a deduction on an income or franchise tax return rather than a capital asset.”

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

The Chief Counsel Memorandum also advised the Board, that “[i]f the Board agrees that, in light of the entire statutory scheme, the Legislature intended to make the partial exemption available in all circumstances where a qualified person can establish that otherwise qualified tangible personal property has a useful life of one year or more, [then,] subject to approval by the Office of Administrative Law [(OAL)], CalTax’s requested amendments will address the issues raised by CalTax and effectuate such legislative intent.”

August 25, 2015, Board Meeting

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

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

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

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

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

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

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

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

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

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

DOCUMENTS RELIED UPON

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

ALTERNATIVES CONSIDERED

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

The Board did not reject any reasonable alternative to the proposed amendments to Regulation 1525.4 that would lessen any adverse impact the proposed action may have on small business or that would be less burdensome and equally effective in achieving the purposes of the proposed action. No reasonable alternative has been identified and brought to the Board's attention that would lessen any adverse impact the proposed action may have on small business, be more effective in carrying out the purposes for which the action is proposed, would be as effective and less burdensome to affected private persons than the proposed action, or would be more cost effective to affected private persons and equally effective in implementing the statutory policy or other provision of law than the proposed action.

INFORMATION REQUIRED BY GOVERNMENT CODE SECTION 11346.2, SUBDIVISION (b)(5) AND ECONOMIC IMPACT ASSESSMENT REQUIRED BY GOVERNMENT CODE SECTION 11346.3, SUBDIVISION (b)(1)

Section 1 of AB 93 specifies that it is the intent of the Legislature in adding RTC section 6377.1 to exempt manufacturing equipment from state sales and use taxes in order to make California more competitive in attracting new businesses to this state. Also, as explained above, the Legislature intended for the partial exemption provided by RTC section 6377.1 to be fully utilized and, to ensure such utilization, RTC section 6377.1, subdivision (g), required the Department of Finance to estimate the total dollar amount of exemptions that will be taken for each calendar year the partial exemption will be in effect and requires the Board to annually report the total dollar amount of exemptions taken for the immediately preceding calendar year, compare the total dollar amount of those exemptions to the Department of Finance's estimate for that same year, and identify options for increasing exemptions taken so as to meet the Department of Finance's estimates when necessary. And, the Board anticipates that RTC section 6377.1 will continue to have an economic impact on business and state revenue as intended the Legislature intended.

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

purposes shall be deemed to have a useful life of less than one year for purposes of this section.”

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

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

The Board has also determined that the proposed amendments to Regulation 1525.4 are fully consistent with current law, including RTC section 6377.1, subject to OAL approval, and there is nothing in the proposed amendments that would significantly change how the Legislature intended for individuals and businesses to behave in response to RTC section 6377.1. Therefore, the Board estimates that the proposed amendments, themselves, will not have a measurable economic impact on individuals and business that is in addition to whatever economic impact RTC section 6377.1 will have on individuals and businesses. And, the Board has determined that the proposed amendments to Regulation 1525.4 are not a major regulation, as defined in Government Code section 11342.548 and California Code of Regulations, title 1, section 2000, because the Board

has estimated that the proposed amendments will not have an economic impact on California business enterprises and individuals in an amount exceeding fifty million dollars (\$50,000,000) during any 12-month period.

In addition, the Board has determined that the proposed amendments to Regulation 1525.4 do not impose any costs on any persons, including businesses, which are not already imposed by RTC section 6377.1, and the Board has determined that there is nothing in the proposed amendments to Regulation 1525.4 that would impact revenue. Therefore, based on these facts and all of the information in the rulemaking file, the Board has determined that the adoption of the proposed amendments to Regulation 1525.4 will neither create nor eliminate jobs in the State of California nor result in the elimination of existing businesses nor create or expand business in the State of California.

Furthermore, Regulation 1525.4 does not regulate the health and welfare of California residents, worker safety, or the state's environment. Therefore, the Board has also determined that the adoption of the proposed amendments to Regulation 1525.4 will not affect the benefits of the regulation to the health and welfare of California residents, worker safety, or the state's environment.

The forgoing information also provides the factual basis for the Board's initial determination that the adoption of the proposed amendments to Regulation 1525.4 will not have a significant adverse economic impact on business.

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

**Text of Proposed Amendments to
California Code of Regulations, Title 18, Section 1525.4,
*Manufacturing and Research & Development Equipment***

1525.4. Manufacturing and Research & Development Equipment.

(a) Partial Exemption for Property Purchased for Use in Manufacturing and Research and Development. Except as provided in subdivision (d), beginning July 1, 2014, and before July 1, 2022, section 6377.1 of the Revenue and Taxation Code (RTC) provides a partial exemption from sales and use tax for certain sales and purchases, including leases, of tangible personal property as described in this regulation.

For the period beginning July 1, 2014, and ending on December 31, 2016, the partial exemption applies to the taxes imposed by sections 6051 (except the taxes deposited pursuant to section 6051.15), 6051.3, 6201 (except the taxes deposited pursuant to section 6201.15), and 6201.3 of the RTC and Section 36 of Article XIII of the California Constitution (4.1875%). The partial exemption does not apply to the taxes imposed or deposited pursuant to sections 6051.2, 6051.5, 6051.15, 6201.2, 6201.5, or 6201.15 of the RTC, the Bradley-Burns Uniform Local Sales and Use Tax Law, the Transactions and Use Tax Law, or Section 35 of Article XIII of the California Constitution.

For the period beginning January 1, 2017, and ending on June 30, 2022, the partial exemption applies to the taxes imposed by sections 6051 (except the taxes deposited pursuant to section 6051.15), 6051.3, 6201 (except the taxes deposited pursuant to section 6201.15), and 6201.3 of the RTC (3.9375%). The partial exemption does not apply to the taxes imposed or deposited pursuant to sections 6051.2, 6051.5, 6051.15, 6201.2, 6201.5, or 6201.15 of the RTC, the Bradley-Burns Uniform Local Sales and Use Tax Law, the Transactions and Use Tax Law, or Section 35 of Article XIII of the California Constitution.

Subject to the limitation set forth above, this partial exemption from tax applies to the sale of and the storage, use, or other consumption in this state, of the following items:

(1) Qualified tangible personal property purchased for use by a qualified person to be used primarily in any stage of the manufacturing, processing, refining, fabricating, or recycling of tangible personal property, beginning at the point any raw materials are received by the qualified person and introduced into the process and ending at the point at which the manufacturing, processing, refining, fabricating, or recycling has altered tangible personal property to its completed form, including packaging, if required.

(2) Qualified tangible personal property purchased for use by a qualified person to be used primarily in research and development.

(3) Qualified tangible personal property purchased for use by a qualified person to be used primarily to maintain, repair, measure, or test any qualified tangible personal property described in subdivision (a)(1) or (2).

(4) Qualified tangible personal property purchased for use by a contractor purchasing that property for use in the performance of a construction contract for the qualified person,

provided that the qualified person will use the resulting improvement on or to real property as an integral part of the manufacturing, processing, refining, fabricating, or recycling process, or as a research or storage facility for use in connection with those processes.

(b) Definitions. For the purposes of this regulation:

(1) “Fabricating” means to make, build, create, produce, or assemble components or tangible personal property to work in a new or different manner.

(2) “Manufacturing” means the activity of converting or conditioning tangible personal property by changing the form, composition, quality, or character of the property for ultimate sale at retail or use in the manufacturing of a product to be ultimately sold at retail. Manufacturing includes any improvements to tangible personal property that result in a greater service life or greater functionality than that of the original property. Tangible personal property shall be treated as having a greater service life if such property can be used for a longer period than such property could have been used prior to the conversion or conditioning of such property. Tangible personal property shall be treated as having greater functionality if it has been improved in such a manner that it is more efficient or can be used to perform new or different functions.

(3) “Packaging” means to wrap, seal, box, or put together as a unit, but includes only that packaging necessary to prepare the goods for delivery to and placement in the qualified person’s finished goods inventory, or to prepare goods so that they are suitable for delivery to and placement in finished goods inventory, including repackaging of such goods when repackaging is required to meet the needs of a specific customer. Packaging necessary to consolidate the goods prior to shipping or to protect them during transportation to the customer shall not be considered to be “packaging” for purposes of this regulation.

(4) “Pollution control” means any activity that results in the abatement, reduction, or control of water, land, or atmospheric pollution or contamination by removing, altering, disposing, storing, or preventing the creation or emission of pollutants, contaminants, wastes, or heat, but only to the extent that such activity meets or exceeds standards established by this state or by any local or regional governmental agency within this state at the time the qualified tangible personal property is purchased.

(5) “Primarily” means 50 percent or more of the time.

(6) “Process” means the period beginning at the point at which any raw materials are received by the qualified person and introduced into the manufacturing, processing, refining, fabricating, or recycling activity of the qualified person and ending at the point at which the manufacturing, processing, refining, fabricating, or recycling activity of the qualified person has altered tangible personal property to its completed form, including packaging as defined in subdivision (b)(3), if required. “Process” includes testing products for quality assurance which occurs prior to the tangible personal property being altered to its completed form, including packaging as defined in subdivision (b)(3), if required. Raw materials shall be considered to have been introduced into the process when the raw materials are stored on the

same premises where the qualified person's manufacturing, processing, refining, fabricating, or recycling activity is conducted. Raw materials that are stored on premises other than where the qualified person's manufacturing, processing, refining, fabricating, or recycling activity is conducted shall not be considered to have been introduced into the manufacturing, processing, refining, fabricating, or recycling process.

(7) "Processing" means the physical application of the materials and labor necessary to modify or change the characteristics of tangible personal property.

(8) (A) "Qualified person" means a person that is primarily engaged in those lines of business described in Codes 3111 to 3399, inclusive, 541711, or 541712 of the North American Industry Classification System (NAICS) published by the United States Office of Management and Budget (OMB), 2012 edition. With respect to Codes 3111 to 3399, a person will not be precluded from the definition of a "qualified person" when there is no applicable six digit NAICS code to describe their line of business, provided that their business activities are reasonably described in a qualified four digit industry group. For example, a business in the recycling industry may be regarded as a qualified person when the activities of the establishment are reasonably described in a qualified four digit industry group. For the purpose of this subdivision:

1. A qualified person may be "primarily engaged" either as a legal entity or as an establishment within a legal entity. "Legal entity" means "person" as defined in RTC section 6005.

A person is "primarily engaged" as a legal entity if, in the prior financial year, the legal entity derives 50 percent or more of gross revenue (including inter-company charges) from, or expends 50 percent or more of operating expenses in a line of business described in Codes 3111 to 3399, inclusive, 541711 or 541712 of the NAICS. For example, a legal entity is a qualified person primarily engaged in a qualifying line of business if the legal entity's gross revenue from manufacturing constitutes 50 percent or more of the total revenue for the legal entity. For purposes of research and development activities, revenues could be derived from, but are not limited to, selling research and development services or licensing intellectual property resulting from research and development activities.

A person is "primarily engaged" as an establishment if, in the prior financial year, the establishment derives 50 percent or more of gross revenue (including inter-company and intra-company charges) from, or expends 50 percent or more of operating expenses in a qualifying line of business. Alternatively, an establishment is "primarily engaged" if, in the prior financial year, it allocates, assigns or derives 50 percent or more of any one of the following to or from a qualifying line of business: (1) employee salaries and wages, (2) value of production, or (3) number of employees based on a full-time equivalency.

For purposes of this test, the gross revenues may be derived from a combination of qualified manufacturing lines of business and from qualified research and

development lines of business. For example, if a company derives 40% of its gross revenues from qualified manufacturing activities and 40% from non-qualified manufacturing activities; but, the remaining 20% of its gross revenues are derived from qualified research and development contracts, the company would qualify because overall, 60% of the gross revenues are from qualifying activities.

Similarly, the test for operating expenses from qualifying manufacturing or research and development lines of business cited in the qualifying NAICS codes would be considered in combination.

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

In the case of a nonprofit organization or government entity, “primarily engaged” with regard to gross revenue means 50 percent or more of the funds allocated to the entity or establishment are attributable to a qualifying line of business.

In cases where the purchaser was not primarily engaged in qualifying manufacturing or research and development activities for the financial year preceding the purchase of the property, the one year period following the date of purchase of the property will be used.

2. For purposes of this subdivision, “establishment” includes multiple or single physical locations (including any portion or portions thereof), and those locations or combinations of locations (including any portion or portions thereof) designated as a “cost center” or “economic unit” by the taxpayer, where a qualified activity is performed, and for which the taxpayer maintains separate books and records that reflect revenue, costs, number of employees, wages or salaries, property and equipment, job costing, or other financial data pertaining to the qualified activity. A physical location may be described in more than one NAICS code.

3. An entity or establishment primarily engaged in manufacturing activities may purchase qualified tangible personal property subject to the partial sales and use tax exemption for use in research and development, provided all other requirements for the exemption are met. An entity or establishment primarily engaged in research and development may purchase qualified tangible personal property subject to the partial sales and use tax exemption for use in manufacturing, provided all other requirements for the exemption are met. Where a person is primarily engaged as a legal entity, that person shall be considered a “qualified person” for purposes of this regulation for all purchases made by the legal entity, provided all other requirements of the exemption are met. Where a person conducts business at more than one establishment then that person shall be considered to be a “qualified person” for purposes of this regulation only as to those purchases that are intended to be used and are actually used in an establishment in which the purchaser is primarily engaged in those lines of business described in Codes 3111 to 3399, inclusive, 541711, or 541712.

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

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

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

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

1. Machinery and equipment, including component parts and contrivances such as belts, shafts, moving parts, and operating structures. For purposes of this subdivision, manufacturing aids as described in Regulation 1525.1, *Manufacturing Aids*, may be considered machinery and equipment, when purchased by a qualified person for use by that person in a manner qualifying for exemption, even though such property may subsequently be delivered to or held as property of the person to whom the manufactured product is sold. The manufacturing aids must meet the useful life requirement of subdivision (b)(13).
2. Equipment or devices used or required to operate, control, regulate, or maintain the machinery, including, but not limited to, computers, data-processing equipment, and computer software, together with all repair and replacement parts with a useful life of one or more years therefor, whether purchased separately or in conjunction with a complete machine and regardless of whether the machine or component parts are assembled by the qualified person or another party.
3. Tangible personal property used in pollution control that meets or exceeds standards established by this state or any local or regional governmental agency within this state at the time the qualified tangible personal property is purchased.
4. Special purpose buildings and foundations used as an integral part of the manufacturing, processing, refining, fabricating, or recycling process, or that constitute a research or storage facility used during those processes. Buildings used solely for warehousing purposes after completion of those processes are not included. For purposes of this subdivision:
 - a. “Special purpose building and foundation” means only a building and the foundation underlying the building that is specifically designed and constructed or reconstructed for the installation, operation, and use of specific machinery and equipment with a special purpose and the construction or reconstruction of which

is specifically designed and used exclusively for the specified purposes as set forth in subdivision (a) (the qualified purpose). Special purpose buildings and foundations also include foundations for open air structures that may not have ceilings or enclosed walls but are used exclusively for the specified purposes as set forth in subdivision (a).

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

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

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

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

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

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

1. Consumables with a useful life of less than one year.
2. Furniture, inventory, and equipment used in the extraction process, or equipment used to store finished products that have completed the manufacturing, processing,

refining, fabricating, or recycling process. The extraction process includes such severance activities as mining, oil and gas extraction.

3. Tangible personal property used primarily in administration, general management, or marketing.

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

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

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

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

(B) For purposes of applying subdivision (b)(13)(A), tangible personal property that meets any one of the following criteria shall be deemed as having a useful life of one or more years for state income or franchise tax purposes:

1. Tangible personal property included under a warranty by the manufacturer or other third party to last one or more years shall be treated as having a useful life of one or more years for purposes of this regulation.

2. Tangible personal property that is included under a maintenance contract lasting one or more years shall be treated as having a useful life of one or more years for purposes of this regulation.

3. Tangible personal property that is normally replaced at intervals of one or more years, as established by industry or business practices or based on the actual

experience of the person claiming the exemption, or is expected at the time of purchase to last one or more years, as established by industry or business practices or based on the actual experience of the person claiming the exemption, shall be treated as having a useful life of one or more years for purposes of this regulation.

(C) Examples: Useful life is determined by answering the following questions for tangible personal property:

Example 1. Is the tangible personal property capitalized for state tax purposes or accounting purposes?

- If the answer is "yes," it meets the useful life requirement.

- If the answer is "no," go to the next question.

Example 2. Is the tangible personal property warranted by the manufacturer or other third party to last one year or more?

- If the answer is "yes," it meets the useful life requirement.

- If the answer is "no," go to the next question.

Example 3. Is the tangible personal property normally replaced at intervals of one year or more, as established by industry or business practice? (This is commonly based on the actual experience of the person claiming the exemption.)

- If the answer is "yes," it meets the useful life requirement.

- If the answer is "no," go to the next question.

Example 4. Is the tangible personal property expected at the time of purchase to last one year or more, as established by industry or business practice? (This is commonly based on the actual experience of the person claiming the exemption.)

- If the answer is "yes," it meets the useful life requirement.

- If the answer is "no," it does not meet the useful life requirement.

(c) Partial Exemption Certificate.

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

On occasion a potential qualified person may not know at the time of purchase whether they will meet the requirements for the purpose of claiming the partial exemption until the expiration of the one year period following the date of purchase as provided in subdivision

(b)(8)(A). The purchaser may issue a partial exemption certificate at the time of the purchase based on the expectation that the purchaser will meet the requirements of the regulation. If those requirements are not met, the purchaser will be liable for payment of sales tax, with applicable interest as if the purchaser were a retailer making a retail sale of the tangible personal property at the time the tangible personal property is purchased.

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

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

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

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

(2) Blanket Partial Exemption Certificate. In lieu of requiring a partial exemption certificate for each transaction, a qualified person may issue a blanket partial exemption certificate. The partial exemption certificate forms set forth in Appendix A and Appendix B may be used as blanket partial exemption certificates. In absence of evidence to the contrary, a retailer may accept an otherwise valid blanket partial exemption certificate in good faith if the certificate complies with the requirements set forth in this subdivision.

When purchasing tangible personal property not qualifying for the partial exemption from a seller to whom a blanket exemption certificate has been issued, the qualified person or contractor must clearly state in a contemporaneous document or documents such as a written purchase order, sales agreement, lease, or contract that the sale or purchase is not subject to the blanket partial exemption certificate.

If contemporaneous physical documentation, such as a purchase order, sales agreement, lease, or contract is not presented for each transaction, any agreed upon designation which clearly indicates which items being purchased are or are not subject to the partial exemption

certificate, such as using a separate customer account number for purchases subject to the partial exemption, will be accepted, provided the means of designation is set forth on the blanket exemption certificate.

(3) Form of Partial Exemption Certificate. Any document, such as a letter or purchase order, timely provided by the purchaser to the seller will be regarded as a partial exemption certificate with respect to the sale or purchase of the tangible personal property described in the document if it contains all of the following essential elements:

(A) The signature of the purchaser, purchaser's employee, or authorized representative of the purchaser.

(B) The name, address and telephone number of the purchaser.

(C) The number of the seller's permit held by the purchaser. If the purchaser is not required to hold a permit because the purchaser sells only property of a kind the retail sale of which is not taxable, e.g., food products for human consumption, or because the purchaser makes no sales in this state, the purchaser must include on the certificate a sufficient explanation as to the reason the purchaser is not required to hold a California seller's permit in lieu of a seller's permit number.

(D) A statement that the property purchased is:

1. To be used primarily for a qualifying activity as described in subdivision (a)(1) – (3), or
2. For use by a contractor purchasing that property for use in the performance of a construction contract for the qualified person as described in subdivision (a)(4).

(E) A statement that the purchaser is:

1. a person primarily engaged in a manufacturing business described in NAICS Codes 3111 to 3399 or in research and development activities as described in NAICS Codes 541711 and 541712 (OMB 2012 edition), or
2. a contractor performing a construction contract for a qualified person primarily engaged in manufacturing business described in NAICS Codes 3111 to 3399 or in a research and development activities as described in NAICS Codes 541711 and 541712 (OMB 2012 edition).

(F) A statement that the property purchased is qualified tangible personal property as described in subdivision (7)(A).

(G) A description of property purchased.

(H) The date of execution of the document.

(4) Retention and Availability of Partial Exemption Certificates. A retailer must retain each partial exemption certificate received from a qualified person for a period of not less than four years from the date on which the retailer claims a partial exemption based on the partial exemption certificate.

(5) Good Faith. A seller will be presumed to have taken a partial exemption certificate in good faith in the absence of evidence to the contrary. A seller, without knowledge to the contrary, may accept a partial exemption certificate in good faith where a qualified person or a contractor performing a construction contract for a qualified person provides a certificate meeting the requirements provided in subdivision (c)(3).

(d) When the Partial Exemption Does Not Apply. The exemption provided by this regulation shall not apply to either of the following:

(1) Any tangible personal property purchased by a qualified person during any calendar year that exceeds two hundred million dollars (\$200,000,000) of purchases of qualified tangible personal property for which an exemption is claimed by the qualified person under this regulation. This limit includes fixtures and materials sold or used in the construction of special purpose buildings and foundations.

For purposes of this subdivision, in the case of a qualified person that is required to be included in a combined report under RTC section 25101 or authorized to be included in a combined report under RTC section 25101.15, the aggregate of all purchases of qualified personal property for which an exemption is claimed pursuant to this regulation by all persons that are required or authorized to be included in a combined report shall not exceed two hundred million dollars (\$200,000,000) in any calendar year.

For the purposes of this subdivision, “calendar year” includes the period July 1, 2014 to December 31, 2014, as well as the period January 1, 2022 to June 30, 2022. Accordingly, for calendar years 2014 and/or 2022, a qualified person may not exceed \$200,000,000 in purchases of qualified tangible personal property for which an exemption is claimed by the qualified person under this regulation.

There is no proration of the \$200,000,000 limit when the purchaser is a qualified person for only a portion of a calendar year. For example, if the qualified person began business on October 1, 2016, the qualified person may purchase up to \$200,000,000 in qualified tangible personal property in the three months of 2016 they were in business.

(2) The sale or storage, use, or other consumption of property that, within one year from the date of purchase, is removed from California, converted from an exempt use under subdivision (a) to some other use not qualifying for exemption, or used in a manner not qualifying for exemption.

(e) Purchaser’s Liability for the Payment of Sales Tax. If a purchaser certifies in writing to the seller that the tangible personal property purchased without payment of the tax will be used in a

manner entitling the seller to regard the gross receipts from the sale as exempt from the sales tax, and the purchaser exceeds the two-hundred-million-dollar (\$200,000,000) limitation described in subdivision (d)(1), or within one year from the date of purchase, the purchaser removes that property from California, converts that property for use in a manner not qualifying for the exemption, or uses that property in a manner not qualifying for the exemption, the purchaser shall be liable for payment of sales tax, with applicable interest, as if the purchaser were a retailer making a retail sale of the tangible personal property at the time the tangible personal property is so purchased, removed, converted, or used, and the cost of the tangible personal property to the purchaser shall be deemed the gross receipts from that retail sale.

(f) Leases. Leases of qualified tangible personal property classified as “continuing sales” and “continuing purchases” in accordance with Regulation 1660, *Leases of Tangible Personal Property – In General*, may qualify for the partial exemption subject to all the limitations and conditions set forth in this regulation. The partial exemption established by this regulation may apply to rentals payable paid by a qualified person for a lease period beginning on or after July 1, 2014, with respect to a lease of qualified tangible personal property to the qualified person, which property is used primarily in an activity described in subdivision (a), notwithstanding the fact that the lease was entered into prior to the effective date of this regulation.

For purposes of this subdivision, in the case of any lease that is a continuing “sale” and “purchase” under subdivision (b)(1) of Regulation 1660, the one-year test period specified in subdivision (d)(2) of this regulation runs from the date of the first rental period which occurs on or after July 1, 2014, provided that the other conditions for qualifying for the partial exemption have been met. Any such rentals payable subject to the partial exemption shall continue to be taxed at the partial rate after expiration of the one-year period and lasting until such time as the lessee ceases to be a qualified person, converts the property for use in a manner not qualifying for the exemption, uses the property in a manner not qualifying for the partial exemption, or the partial exemption otherwise ceases to apply.

(g) Construction Contractors. The application of sales and use tax to construction contracts is explained in Regulation 1521, *Construction Contractors*. The terms “construction contract,” “construction contractor,” “materials,” “fixtures,” “time and material contract,” and “lump sum contract” used in this regulation refer to the definitions of those terms in Regulation 1521. Nothing in this regulation is intended to alter the basic application of tax to construction contracts.

(1) Partial Exemption Certificates. As provided in subdivision (c)(1), construction contractors performing construction contracts for construction of special purpose buildings and foundations should obtain a partial exemption certificate from the qualified person (Appendix A). Contractors purchasing property from a retailer in this state or engaged in business in this state for use in the performance of a qualifying construction contract for a qualified person must timely furnish the retailer with a partial exemption certificate in order for the partial exemption to be allowed (Appendix B).

If a contractor accepts a certificate from a qualified person for the construction of a special purpose building or foundation and it is later determined that the building or foundation is

not a qualifying structure as provided in subdivision (b)(9)(A)4., the qualifying person will be liable for the tax as provided in subdivision (e). If a contractor issues a certificate to its vendor to purchase tangible personal property for use in a construction contract for a qualified person subject to the partial exemption, and instead uses those materials for another purpose, the contractor will be liable for the tax as provided in subdivision (e).

(2) Construction Contractors as Qualified Persons. Equipment used by a construction contractor in the performance of a construction contract for a qualified person does not qualify for the partial exemption. For example, the lease of a crane used in the construction of a special purpose building does not qualify. However, a contractor that is also a qualified person as defined in subdivision (b)(8) may purchase property subject to the partial sales and use tax exemption provided all requirements for exemption are met. Like any other qualified person, a contractor making purchases qualifying for the exemption is subject to the \$200,000,000 limit provided in (d)(1) with regard to the contractor's purchases for his or her own use.

(3) \$200,000,000 Limit. As explained in subdivision (d)(1), the \$200,000,000 limit for the partial exemption includes fixtures and materials sold or used in the construction of special purpose buildings and foundations. In a time and material contract, the qualified person may consider the billed price of materials and fixtures to be the purchase price of these items for the purposes of the limit. In a lump-sum contract, the qualified person must obtain this information from job cost sheets or other cost information provided by the construction contractor.

(h) Claim for Refund. Qualified purchasers, or contractors purchasing qualified tangible personal property for use in the performance of a construction contract for a qualified person, who paid tax or tax reimbursement to the seller or the Board may file a claim for refund with the Board if the purchase was a use tax transaction. However, if the purchase was a sales tax transaction, a claim for refund for sales tax must be filed by the retailer who reported the sale and the qualified purchaser must issue the seller a partial exemption certificate. In order to be timely, the claim for refund must be filed with the Board within the period specified in section 6902 of the RTC.

Note: Authority cited: Section 7051, Revenue and Taxation Code. Reference: Section 6377.1, Revenue and Taxation Code.

Appendix A

PARTIAL EXEMPTION CERTIFICATE FOR MANUFACTURING AND RESEARCH & DEVELOPMENT EQUIPMENT – SECTION 6377.1

This is a partial exemption from sales and use taxes at the rate of 4.1875% from July 1, 2014 to December 31, 2016, and at the rate of 3.9375% from January 1, 2017 to June 30, 2022. You are not relieved from your obligations for the remaining state tax and local and district taxes on this transaction. This partial exemption also applies to lease periods occurring on or after July 1, 2014 and before July 1, 2022, for leases of qualified tangible personal property even if the lease agreement was entered into prior to July 1, 2014.

I hereby certify that the tangible personal property described below and purchased or leased from:

SELLER'S/LESSOR'S NAME
SELLER'S/LESSOR'S ADDRESS (Street, City, State, Zip Code)

is qualified tangible personal property and will be used by me primarily (please check one):

- 1. for manufacturing, processing, refining, fabricating, or recycling;
- 2. for research and development;
- 3. to maintain, repair, measure, or test any property being used for (1) or (2) above; **or**
- 4. as a special purpose building and/or foundation.

Description of qualified tangible property purchased or leased¹:

If this is a specific partial exemption certificate, provide the purchase order or sales invoice number and a precise description of the property being purchased. If you want this certificate to be used as a blanket certificate for future purchases, describe generally the type of property you will be purchasing and ask your vendor to keep this certificate on file.

I, as the undersigned purchaser, hereby certify I am primarily engaged in manufacturing, processing, refining, fabricating, or recycling as described in Codes 3111 to 3399 of the North American Industry Classification System (NAICS)² or I am primarily engaged in biotechnology, or physical, engineering, and life sciences research and development as described in Codes 541711 and 541712 of the NAICS.

I understand that by law, I am required to report and pay the state tax (calculated on the sales price/rentals payable of the property) at the time the tangible personal property is so purchased, removed, converted, or used if:

- the purchase exceeds the \$200 million limitation;
- the property is removed from California within one year of the date of purchase or lease;
- converted for use in a manner not qualifying for the exemption; **or**
- used in a manner not qualifying for the partial exemption.

NAME OF PURCHASER	SIGNATURE OF PURCHASER, PURCHASER'S EMPLOYEE, OR AUTHORIZED REPRESENTATIVE
PRINTED NAME OF PERSON SIGNING	TITLE
ADDRESS OF PURCHASER	TELEPHONE NUMBER
PERMIT NUMBER (IF YOU ARE NOT REQUIRED TO HOLD A PERMIT, EXPLAIN WHY)	DATE
EMAIL ADDRESS OF PERSON SIGNING	

¹ See Regulation 1525.4, subdivision (b)(9) for a description of what is included and excluded from "qualified tangible personal property."

² Published by the US Office of Management and Budget, 2012 edition.

Appendix B

CONSTRUCTION CONTRACTS - PARTIAL EXEMPTION CERTIFICATE FOR MANUFACTURING AND RESEARCH & DEVELOPMENT EQUIPMENT – SECTION 6377.1

This is a partial exemption from sales and use taxes at the rate of 4.1875% from July 1, 2014 to December 31, 2016, and at the rate of 3.9375% from January 1, 2017 to June 30, 2022. You are not relieved from your obligations for the remaining state tax and local and district taxes on this transaction.

I hereby certify that the tangible personal property described below and purchased from:

SELLER'S/LESSOR'S NAME

SELLER'S/LESSOR'S ADDRESS (Street, City, State, Zip Code)

is qualified tangible personal property and will be used by me in the performance of a construction contract for a qualified person who will use that property as an integral part of the manufacturing, processing, refining, fabricating, or recycling process, or as a research or storage facility for use in connection with those processes.

Description of qualified tangible property purchased¹:

If this is a specific partial exemption certificate, provide the purchase order or sales invoice number and a precise description of the property being purchased. If you want this certificate to be used as a blanket certificate for future purchases, describe generally the type of property you will be purchasing and ask your vendor to keep this certificate on file.

I further certify I am performing a construction contract for a qualified person primarily engaged in manufacturing, processing, refining, fabricating, or recycling as described in Codes 3111 to 3399 of the North American Industry Classification System (NAICS)² or primarily engaged in biotechnology, or physical, engineering, and life sciences research and development as described in Codes 541711 and 541712 of the NAICS.

I understand that if I use the property for any purpose other than indicated above, I am required to report and pay the state tax measured by the sales price of the property to me.

NAME OF PURCHASER	SIGNATURE OF PURCHASER, PURCHASER'S EMPLOYEE, OR AUTHORIZED REPRESENTATIVE
PRINTED NAME OF PERSON SIGNING	TITLE
ADDRESS OF PURCHASER	
PERMIT NUMBER (IF YOU ARE NOT REQUIRED TO HOLD A PERMIT, EXPLAIN WHY)	TELEPHONE NUMBER
EMAIL ADDRESS OF PERSON SIGNING	DATE

¹ See Regulation 1525.4, subdivision (b)(9) for a description of what is included and excluded from "qualified tangible personal property."

² Published by the US Office of Management and Budget, 2012 edition.

Regulation History

Type of Regulation: Sales and Use Tax

Regulation: 1525.4

Title: *Manufacturing and Research & Development Equipment*

Preparation: Bradley Heller

Legal Contact: Bradley Heller

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

History of Proposed Regulation:

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

Sponsor: NA

Support: NA

Oppose: NA