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March 10, 1997

VIA FACSIMILE AND U.S. MAIL

Mr. W--- G. L---
A--- A--- ---
--- Street ---
--- ---, Suite XXXX
---, California XXXXX-XXXX

Re: I--- Corporation
Account No. SC -- XX-XXXXXX

Dear Mr. L---:

This is in response to your letter dated February 3, 1997 asking whether your client, the I--- Corporation (hereafter "I---"), qualifies for the partial sales and use tax exemption set forth in Revenue and Taxation Code section 6377¹ and Title 18, California Code of Regulations (hereafter "Regulation"), section 1525.2.

You state:

"I--- is a developer and manufacturer of computer disk drives, the company incorporated in 19XX and is primarily located in Utah. I--- has two research and development facilities in California that design prototypes, these facilities opened in 19XX and 19XX.

"The research and development facilities provide internal services for I--- and are not part of the manufacturing process. These facilities do not provide services to any third parties or sell any products.

"Until recently, I--- manufactured all products outside California. I--- began subcontracting the manufacture of component parts with three California companies beginning in June 19XX, and began subcontracting for finished products and repair with a California company beginning in February 19XX. I--- purchases all manufacturing machinery and raw materials and has complete product control related to the subcontracting activities in California. The

¹ All further references are to the Revenue and Taxation Code unless otherwise noted.

subcontractor only supplies the manufacturing labor and facility for the machinery.

“

“I--- provides all Technical data, Technology, Inventions and Manufacturing Packages (defined as the required manufacturing flow, product specifications, assembly instructions, test instructions and specifications, bill of materials, process controls, packaging and labeling instructions, tooling, fixtures, spare parts and test equipment) required to manufacture the products solely for I---

“I--- has transferred three transporter build lines and associated test equipment for the product. The lines plus other I--- provided equipment will be used on a production basis to manufacture the product. The equipment will be owned by I--- and consigned to the subcontractor and will be returned to I--- at I---’s expense promptly after the termination or expiration of the agreement

“I--- will provide all materials, including packaging, required to manufacture the product. I--- will ensure delivery of the product and will be responsible for all order placement, supplier management, freight and insurance. The materials will be source inspected by I--- or I--- will compensate the subcontractor for receiving inspection and provide specifications, processes and a sampling plan required to perform the receiving inspection

“Any engineering changes are at the discretion of I---, not the discretion of the subcontractor. Engineering changes mean mechanical, electrical, firmware or software design changes or specification changes, process changes, piece part or subassembly design or specification changes, if made to the products to be delivered which would affect the schedule, performance, reliability, availability, serviceability, appearance, dimensions, tolerance, safety or cost of the products, or in I---’s opinion would eventually require additional approval tests In the event of an engineering change, I--- shall notify the subcontractor of the disposition that is to be made of any components, material and/or units of product

“I---’s representatives are allowed access to Subcontractor’s facilities for the purpose of monitoring production processes or for audits of quality and process control procedures

“Delivery of the product shall be either to I--- or pursuant to I---’s instructions and the delivery F.O.B. point is the subcontractor’s facilities. I--- pays all duties, taxes, shipping, customs, insurance, and handling charges after the F.O.B. point

“The subcontractor agrees only to apply I--- supplied labels on all units of the product which will include the appropriate I--- patent, copyright or maskwork notice in accordance with the agreed upon labeling specifications

“The right to use the intellectual property made available by I--- to the subcontractor shall terminate upon the termination of the contract and the subcontractor agrees to cease using any I--- intellectual property or any other I--- information supplied under the agreement in any manner

“All discoveries, improvements, inventions and trade secrets made in the performance of the agreement including but not limited to either the process of the products (i) solely by I--- personnel during the term of this agreement or (ii) jointly by the subcontractor and I--- personnel shall be the sole and exclusive property of I--- and I--- shall retain any and all rights to file any patent application thereon

“The subcontractor’s warranty does not cover design related problems in the products, and material related problems, or customer damage claims”

You ask that this Agency approve I---’s application for a section 6377 exemption certificate provided with your letter. To facilitate our response, you also provided a copy of a sample contract between I--- and one of its California subcontractors for purposes of our review.

Discussion

The partial sales and use tax exemption is generally available to persons that commence a new trade or business (discussed below) on or after January 1, 1994 inside this state which is described in codes 2011 to 3999 of the 1987 Standard Industrial Classification Manual (hereafter "SIC code"). A new trade or business is one which a person (or any related person) has not engaged in within the preceding 36 months inside this state² or which is classified in a different division of the SIC code than that person's (or any related person's) current or prior trade or business activities in this state. (Rev. & Tax. Code § 6377(b)(5)(A)(ii).)³ That is, a person must not be regarded as having engaged in a manufacturing activity inside this state within the 36 months preceding the time it actually engages in the new trade or business activity inside this state. The new trade or business must also commence its new manufacturing operations inside this state on or after January 1, 1994. (Reg. 1525.2(c)(5)(A).)

I---’s operations inside this state between 1991 and June, 1995 consisted of research and development activities for computer hardware unrelated to manufacturing activities. We assume these operations fell within SIC industry code 8731, “Commercial Physical and Biological Research.” In June 1995, I--- began contracting with various California companies for the manufacture of finished products. I--- provided manufacturing equipment, raw materials and the technical specifications for the manufacture of these items by the California companies. The

² Section 6377 makes a distinction between persons engaged in a trade or business inside the state and those that are not. Persons engaged in business wholly outside the state who commence a manufacturing business in California on or after January 1, 1994 qualify as a new trade or business regardless of that person's prior trade or business activity. (See Rev. & Tax. Code § 6377(b)(5)(A)(iii).)

³ “New trade or business” status is further limited in situations where a person acquires the assets of another business. (See Rev. & Tax. Code § 6377(b)(5)(A)(i).) Since we understand that I--- did not acquire the assets of another business inside California, we will not address the acquisition provisions of the partial sales and use tax exemption.

California companies provide manufacturing labor and the facilities necessary to manufacture the finished items. We understand that the California companies providing the manufacturing labor and facilities are already engaged in a manufacturing activity described in SIC codes 2011 through 3999.

Based on the above facts, the California companies contracting with I--- are performing the manufacturing of the finished products. These companies may qualify for the partial exemption if they meet all the requirements of section 6377 and Regulation 1525.2. I--- does not, however, qualify for the partial exemption merely by providing equipment, materials and specifications to these companies. That is, I---'s operations inside this state do not fall with SIC code operations 2011 through 3999 by way of its contracts with the California companies. We are therefore unable to approve I---'s application for a section 6377 exemption certificate.

If you have any further questions, please write again.

Sincerely,

Warren L. Astleford
Senior Tax Counsel

WLA:rz

cc: --- District Administrator - (--)
Mr. Rudy O. Ahumada (Mic: 40)