



STATE BOARD OF EQUALIZATION

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February 26, 1996

BURTON W. OLIVER
Executive Director

Mr. D--- L. T---
C--- & L---
XXX --- Street
--- ---, California XXXXX-XXXX

Re: S--- A--- R---, Inc.
Account No. SS --- XX-XXXXXX

Dear Mr. T---:

This is in response to your January 29, 1996 letter to Mr. Dennis Fox requesting reconsideration of the Board's denial of a Revenue and Taxation Code¹ section 6377 partial sales and use tax exemption certificate to your client, S--- A--- R---, Inc. (hereafter "SAR").

You state:

"S--- A--- R---, Inc. ... is a food manufacturer. SAR was incorporated on October 6, 1994. SAR became a qualified corporation on March 21, 1995. SAR is a wholly owned subsidiary of K--- F--- Inc. ("K---"). K---'s standard industrial classification code ("SIC") is 2096. SAR's SIC code is 2898. Both SIC's are assigned from the Standard Industrial Classification Manual (1987 Edition).

"K--- is a fully integrated food manufacturing company and its California operations consist of food manufacturing. As a normal part of K---'s business development, a new line of business was developed in 1994 which became SAR. The new line of business manufactures animal feed from other food by-products. A business site was found in ---, California and on June 1, 1995, SAR started its operations.

"During the development stage of SAR in 1994, K--- received notification from the SBE concerning California's new statute CRTS § 6377 for partial exemption

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

of sales and use tax and the California Franchise/Income Tax Investment Tax Credit. As you are aware of, Regulation 1525.2 did not exist during 1994 and the first half of 1995, SAR relied in good faith on CRTC § 6377 to perfect their exemption application.”

Your client was denied a section 6377 partial sales and use tax exemption certificate by way of correspondence from the Board dated June 9, 1995. You request clarification as to whether it was appropriate to deny qualification to SAR on the basis that its corporate parent, K---, is engaged in a manufacturing operation classified under division “D” of the 1987 Standard Industrial Classification Manual (“SIC manual”).

Discussion

Section 6377 was originally enacted by SB 671. The SB 671 version of section 6377 provided an exemption from the state component of the sales and use tax, which is imposed at the rate of 6 percent. Section 6377 was thereafter amended by the passage of SB 676, which became operative on January 1, 1995. As of January 1, 1995, the partial sales and use tax exemption provided by section 6377 was significantly revised which, among other things, reduced the exemption to tax imposed of 5 percent. Thus, if a sale meeting the requirements of the section 6377 partial exemption occurred in 1994 in a district where the sales tax rate is 7-3/4 percent, tax of 1-3/4 percent would be due. If a qualifying sale occurs in that district in 1995, tax of 2-3/4 percent is due.

Pursuant to the SB 676 version of section 6377, the partial sales and use tax exemption generally applies to persons that commence a new trade or business on or after January 1, 1994 inside this state which is described in codes 2000 to 3999 of the 1987 SIC manual. A person meeting these requirements is a "qualified person"; however, a qualified person does not include a person who undertakes a manufacturing activity inside this state within the same SIC code division as a prior trade or business operated by that person (or any related person within the meaning of sections 267 and 318 of the Internal Revenue Code) inside this state within the previous 36 months. The partial sales and use tax exemption generally applies to the sale or use of tangible personal property used primarily for manufacturing, processing, refining, fabricating, recycling, research and development and the repair of qualified property.

Section 6377 makes a distinction between persons who are or were previously engaged in a trade or business inside this state and those that are not for purposes of determining “qualified person” status. A new trade or business is generally one which a person (or any related person) has not engaged in within the preceding 36 months inside this state or which is classified in a different SIC code division 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).) This means that a person currently or previously engaged in a trade or business activity in this state within the preceding 36 months is a “qualified person” only if that person’s (or related person’s) current or previous activity inside this state is in a non-division D SIC code activity and that person undertakes a new trade or business activity in California described in division D of the

SIC manual. On the other hand, persons engaged in a trade or business activity wholly outside the state who commence doing 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).) Under either scenario, the new trade or business must commence such operations inside this state on or after January 1, 1994. (Reg. 1525.2(c)(5)(A).) We generally regard business operations to begin upon the acquisition of operating assets that are necessary to the type of business contemplated. (See Reg. 1525.2(c)(5)(A)1.)²

As an alternate to the partial sales and use tax exemption, SB 676 provides a manufacturer's investment credit ("MIC") (see Rev. & Tax. Code §§ 17053.49, 23649) for purchases of certain qualified property by persons engaged in those lines of business described in SIC code 2000 to 3999. The MIC is 6 percent (1 percent higher than the partial sales and use tax exemption contained in SB 676) and is allowed only where the qualified taxpayer does not elect to take the partial exemption. (See Rev. & Tax. Code §§ 17053.49(a)(1); (b)(1)(B); 23649(a)(1); (b)(1)(B).) Questions regarding the application of the MIC should be addressed to the Franchise Tax Board - Legal Division, P.O. Box 1468, Sacramento, California 95812-1468.

You do not dispute that K--- has been engaged in manufacturing activities inside California within the previous 36 months. These activities consist of the manufacture of potato chips, corn chips, and similar snacks as described in division D of the SIC manual under industry code 2096. We also understand from your letter that you do not dispute that K--- is a related person to SAR within the meaning of 267 and 318 of the Internal Revenue Code. As such, SAR's operation does not qualify as a new trade or business for purposes of the partial sales and use tax exemption since a person related to SAR has been engaged in a division D manufacturing activity inside this state within the previous 36 months.

You assert that section 6377 should be interpreted to allow an existing California business that is engaged in a manufacturing operation to qualify for the partial sales and use tax exemption when it begins a new, but different, manufacturing operation. You believe that the comments made during the first public hearings on Sales and Use Tax Regulation 1525.2 provide this opportunity to those types of businesses. We note, however, that the initial comments on Regulation 1525.2 were based on the language of SB 671 and not the final form of section 6377 as provided for by SB 676. SB 676 contained the express language set forth above which prevents a company engaged in a manufacturing operation in California from obtaining "qualified person" status if a person related to that company is already engaged in a different manufacturing operation. We also note that section 6377(b)(5)(A)(ii), as amended by SB 676, makes specific reference to the requirement that any additional business undertaken by a person (or related person) presently engaged in a trade or business in this state (or previously engaged within the previous 36 months) must be classified under a *different division of the SIC code* to be a "qualified person." This requirement is not a creation of the Board's staff, but instead is the specific design of the California Legislature that the Board may not ignore.

² "New trade or business" status is further limited in situations where a person acquired the assets of another business. (See Rev. & Tax. Code § 6377(b)(5)(A)(i) et seq.) We have not discussed these provisions since you do not indicate that SAR (or K---) acquired the assets of another business in order to engage in its present operations.

You also believe that the term "division" should be interpreted to mean industry code as set forth in the SIC manual. This belief is, however, inconsistent with the plain language of section 6377 and the structure of the SIC manual itself. As set forth above, the Legislature has specifically mandated that the "division" be the standard in determining whether a person qualifies as a new trade or business. Second, the SIC manual is clear as to the meaning of the term division. The SIC manual identifies a division as the largest classification standard within the SIC manual. These classification standards range from the broadest to smallest classifications as follows: division, major group, industry group, and industry code. Thus, SIC code division D contains industry codes 2000 through 3999 and cannot be interpreted in any different way.

We are mindful of the differences that the partial sales and use tax exemption and the MIC have on the cash flow of a business as well as the availability of each tax savings provision to qualified persons. Nevertheless, the California Legislature has opted to not regard a person as "qualified" for purposes of the partial sales and use tax exemption where that person (or any related person) is or was previously engaged in a manufacturing operation inside this state. Regulation 1525.2 adopted by the Board is consistent with that Legislative mandate.

If you have any further questions regarding the partial sales and use tax exemption, please write again. If you have any questions regarding the MIC, please write the Franchise Tax Board at the address noted above.

Sincerely,

Warren L. Astleford
Staff Counsel

WLA:rz

cc: Mr. Dennis Fox (MIC: 92)
Mr. Jerry W. Cornelius (MIC: 67)
--- --- District Administrator (--)