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November 1, 1994

BURTON W. OLIVER
Executive Director

SENT BY FAX AND REGULAR MAIL

Mr. J--- C---
E--- & Y---
XXX --- ---, Suite XXX
---, CA XXXXX

Re: **T---M--- Industries**

Dear Mr. C---:

This is in response to your letter dated August 2, 1994, in which you request our opinion on two specific questions relating to the partial sales and use tax exemption provided in section 6377 of the Revenue and Taxation Code.¹ We delayed responding while the board staff, with industry's assistance, worked on the regulation to interpret and apply Senate Bill (SB) 671. We also waited while the legislature worked out the kinks in the partial sales and use tax exemption through the passage of SB 676. We can now provide you answers with more certainty than previously possible. We apologize for the delay in processing your letter.

You have asked us the following questions with reference to the purchase by XYZ of a skid-mounted methanol plant as described in your previous letter dated February 28, 1994:

1. Will the components of the methanol plant qualify as "special purpose buildings?"
2. Will the concrete pads qualify as "special purpose foundations?"

¹Unless otherwise specifically provided, all section references are to the Revenue and Taxation Code.

Discussion

The sales tax imposed in California is comprised of several components. One is the state component that currently totals six percent. (§§ 6051, 6051.2, 6051.3, and 6051.5.)² Another component is the tax imposed pursuant to the Bradley-Burns Uniform Local Sales and Use Tax Law, that is imposed at the rate of 1-1/4 percent. (§§ 7200 et seq.) Any sales tax above 7-1/4 percent is imposed pursuant to the Transactions and Use Tax Law. (§§ 7251 et seq.)

Section 6377 was originally enacted by SB 671. As originally enacted, this section provides an exemption from the state component of the sales and use tax that, as set forth above, is imposed at the rate of six percent. Thus, under Section 6377 as originally enacted, even when a sale satisfies this exemption, a sales tax will still remain due to the board to the extent that the tax would have exceeded six percent.³

Section 6377, however, was recently amended by SB 676, which becomes operative on January 1, 1995. As of January 1, 1995, the exemption provided by Section 6377 is reduced to affect only five percent of the total sales tax that might otherwise have been due. Thus, if a qualifying sale occurs in 1994 in a district where the sales tax rate is 7-3/4 percent, then a sales tax of 1-3/4 percent will be due. Alternatively, however, if that sale takes place in 1995, then a sales tax of 2-3/4 percent will be due.

For the remainder of this opinion, I will refer to the Section 6377 exemption as a partial sales tax exemption; that is, an effective six percent exemption during 1994, and five percent thereafter.

In addition, prior to addressing your specific questions, please note that SB 676 made several material changes to the language of Section 6377. One change, the above-referenced reduction of the exemption from six percent to five percent, is effective only on and after January 1, 1995. Other changes, however, appear simply to set forth the legislature's intention with more specificity than previously was done in SB 671; for example, as to exactly what constitutes a "new trade or business" in differing factual contexts. Some of these modifications appear to be consistent with the terms and conditions of the statute as originally adopted. Thus, in order to carry out the legislative intent, the proposed board regulation implementing Section 6377 might simply adopt some of these conforming provisions from SB 676 and, via the regulatory process, apply them to transactions occurring between January 1, 1994 and January 1, 1995.

²Similarly, the state component of the use tax also totals six percent.

³The total sales tax will exceed six percent by at least 1-1/4 percent, plus any transactions tax imposed in the relevant district.

With the above in mind, you need to review the following:

- (1) subsection (b)(5)(A)(ii) of amended Section 6377, with regard to the definition of a "new trade or business;" and
- (2) subsections (c)(5)(A)(2), (c)(5)(A)(3), and (c)(5)(A)(4) of the newly-published version of proposed Sales and Use Tax Regulation 1525.2.

Pursuant to these provisions, a trade or business is not a new trade or business in this state if, within the 36 months preceding the date that activities were first commenced in that trade or business in this state, either the person claiming the exemption, or any related person, had conducted any activities in this state in any trade or business classified under the same **division** of the Manual as that trade or business.⁴

There are eleven "divisions" of industries in the SIC Manual. For instance, Division A is "Agriculture, forestry, and fishing," Division B is "Mining," etc. But the important fact is that all manufacturing activities are included in one division -- namely, Division D. Thus, if XYZ, or any related party, has been involved in any manufacturing activities in this state during the referenced time period, then XYZ will not be a qualified person for purposes of this exemption.

While the "first formed or organized" language has been deleted from Section 6377 by SB 676, both the amended statute and the modified proposed regulation still require the "qualified person" to have first commenced business activities in a new trade or business in this state on or after January 1, 1994.

Turning to your specific questions, our responses are as follows:

1. **Will the components of the methanol plant described in the attached letter qualify as "special purpose buildings," as described in proposed Sales and Use Tax Regulation 1525.2?**

In responding to this question, I will not repeat the comments set forth in our original reply dated June 22, 1994, except to the extent that we are modifying our opinion.

You have represented that the "qualified person" will be engaged in the manufacturing trade or business described in Industry No. 2869 of the SIC Manual. Thus, any special purpose buildings and foundations that are "used as an integral part of [this] manufacturing ... process" will be considered to be "tangible personal property" for purposes of this exemption. (See

⁴The SIC Code Manual classifies types of trades or businesses in the following order of increasing specificity:

(1) Divisions - classified by the letters A through K; (2) Major Industry Groups - classified by a two-number code; (3) Industry Groups - classified by a three-letter code; and (4) Industries - classified by a four-letter code.

proposed Sales and Use Tax Regulation 1525.2, subsections (c)(8)(A) and (c)(9)(D). Pursuant to subdivision (6) of (c)(9)(D):

For purposes of this subdivision, the term "integral part" means that the special purpose building or foundation (i) is used directly in the activity qualifying for the exemption from sales and use tax and (ii) 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.

As we earlier informed you, we have decided that the term "building" as used in the statute is not limited just to "buildings" in the common, everyday use of that word. In other words, an improvement constructed on real property may qualify as a "building" even if it does not have a floor, four walls, a ceiling, and a roof. For purposes of the proposed regulation, we will, in fact, consider a "building" simply to be a work of improvement constructed on real property. Thus, as a consequence, the components of a methanol plant are not necessarily excluded from qualification as a "building" for purposes of the proposed regulation.

Nevertheless, the components of the plant must still meet the statutory and regulatory "special purpose" criteria in order to qualify for this exemption. With this in mind, as earlier discussed, there appears to be some question as to whether or not the "storage tanks" you list among the plant components, in fact, are intended for use in an "integral part" of the methanol manufacturing process.⁵ Thus, the factual issue remains as to whether or not the tanks are to be used for storage or "warehousing" purposes or, on the other hand, as an integral part of the manufacturing process.⁶

2. Will the concrete pads qualify as "special purpose foundations," as described in proposed Sales and Use Tax Regulation 1525.2(c)(9)(D)(1)?

Our opinion on this matter is subject to all of the conditions and caveats previously expressed. Nevertheless, pursuant to the referenced subparagraph of the proposed regulation, to the extent that any portion of the methanol plant might be considered to be a special purpose

⁵In this case, some of the storage tanks might be found to be integrally used in the manufacturing process, while others are found to merely be used for warehousing purposes. Obviously, those storage tanks used for warehousing purposes do not qualify for the exemption.

⁶In the event that the entire methanol plant does not qualify as a special purpose building, then, pursuant to Proposed Regulation 1525.2(c)(9)(D)(4), you may attempt to "establish that a portion of a building, and the foundation immediately underlying the portion, qualifies for treatment as a special purpose building and foundation if the portion satisfies all of the definitional provisions in this subparagraph."

building, then that "foundation immediately underlying " that portion of the plant would be considered also to be special purpose within the meaning of this regulation.

If your client meets the above requirements, it should apply for a partial sales tax exemption certificate. That client should include a copy of our two letters along with a completed application form when it does so.

We hope this answers your questions regarding the partial sales tax exemption. If you have any further questions about the partial sales tax exemption after reviewing the provisions of SB 676 and the new proposed regulation, then please write again.

Very truly yours,

Robert W. Lambert
Senior Staff Counsel

RWL:plh

cc: Mr. Glenn Bystrom MIC:43
Mr. Gary Jugum MIC:82
Mr. Gordon Adelman MIC:82
Ms. Pat Parker MIC:40
Mr. Warren Astleford MIC:82