

**STATE BOARD OF EQUALIZATION**

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September 18, 2000

JAMES E. SPEED
Executive Director

Re: Unidentified Taxpayer

Dear _____,

Your August 3, 2000 letter to former Executive Director Les Sorensen was referred to the Legal Division for response. You ask how tax applies to two separate transactions undertaken by your unidentified client (hereafter "the Company"). My response below does not come within the provisions of Revenue and Taxation Code section 6596¹ or Title 18 California Code of Regulations (hereafter "Regulation" or "Reg.") section 1705 since you failed to identify your client and possibly all relevant facts regarding the various transactions.

You raise two separate factual scenarios. For purposes of clarity, I have separately responded to each scenario below.

"Issue #1: Manufacturer's Sales & Use Tax Exemption*"Facts*

"The Company is a manufacturer of various types of clothing, which it sells on a wholesale basis, to retailers such as Wal-Mart, Sears, etc. for resale to customers. The manufacturing process for the garments often begins in one plant and continues through several plants as goods-in-process until the finished product is completed in the final plant and is ready for sale. Various types of industrial machinery and equipment are used in the integrated manufacturing process. This process is typical for the industry in that it can be segregated into three functional segments: (1) Receiving; (2) Manufacturing/Processing; and, (3) Distribution.

"1) Receiving involves the movement of unfinished materials from trucks into the materials storage area. To accomplish this receiving function, equipment such as forklifts, conveyors, reusable transport containers and other material storage and handling devices are utilized. Upon receipt the unfinished material is temporarily held on racks and shelving located in the storage area until ready for the continuation of the manufacturing process.

"2) Manufacturing/Processing involves the introduction of unfinished materials onto the production line where it is transformed from one state to another. This transformation includes, but is not limited to, knitting, dyeing, cutting, sewing, washing, pressing and packaging. To accomplish this Manufacturing/ Processing function, many types of equipment are utilized. These include:

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

weaving looms, dye tanks, computerized cutting machines, sewing machines, washers and dryers, steam presses and packaging equipment.

"3) Distribution involves the movement of partially finished materials from the production line into another temporary storage area. When ready for shipment, the goods-in-process are moved from storage onto trucks where they are transported to other plants for further Manufacturing/Processing, or at the last plant, the finished goods are transported to the Company's customers. To accomplish this distribution function, equipment such as forklifts, conveyors, reusable transport containers and other material storage and handling devices are utilized.

"...The various Manufacturing/Processing functions described above occur within four separate yet integrated plants, each situated several miles from the other... Plant A performs knotting and dyeing of the fabric; Plant B performs cutting of the dyed fabric; Plant C performs the sewing of the cut fabric pieces into garments; and, Plant D performs the washing, drying, pressing and packaging of the garments for shipment as commercially marketable products... No single plant manufactures a finished commercially marketable product..."

You ask our opinion as to whether:

"1) [T]he manufacturing process begins in Plant A and ends in Plant D ... [such that] ... only receiving equipment in Plant A and distribution equipment in Plant D should be excluded from the exemption. All other receiving and distribution equipment utilized between Plants A and D ... qualif[ies] for the manufacturer's exemption.

"2) For plants which are part of an integrated multi-state Manufacturing/Processing network, the manufacturer's exemption should apply to receiving and distribution equipment purchased by each plant provided it is not the first or last plant in the integrated manufacturing process. If such plant were last in the manufacturing process, then distribution equipment should be disallowed while receiving equipment should qualify for exemption."

The provisions of section 6377 and Regulation 1525.2 (hereafter "the partial exemption") are generally available to persons that commence a new trade or business on or after January 1, 1994 inside this state which is described in industry numbers 2011 to 3999 of the 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 state 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.² (§ 6377(b)(6)(A)(ii).) A person must be both pre-qualified and either registered to hold a seller's permit or maintain a consumer use tax account to claim the partial exemption. (Reg. 1525.2(f).)

You correctly note that the partial exemption only applies to property used primarily in manufacturing beginning at the point where raw materials are received by the qualified person and are introduced into the manufacturing process. (See Reg. 1525.2(a)(1).) Raw materials are considered introduced into the manufacturing process when they are stored on the same premises where the qualified person's manufacturing activities are conducted. (Reg. 1525.2(a)(1)(A).) Raw materials not stored on the premises where manufacturing activities are conducted are not considered introduced into the manufacturing process. (*Id.*)

You state that each of the Company's manufacturing activities occur at separate plants at different geographic locations. We understand that each location undertakes some separate function in 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 operation 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 § 6377(b)(5)(A)(iii).)

manufacturing of the finished tangible personal property such that each location actually receives some form of raw materials in an uncompleted state. Pursuant to Regulation 1525.2(a)(1), we regard the manufacturing at each of these locations to begin when each location receives unfinished materials from a previous manufacturing facility or from the vendor to the first manufacturing location. The transportation, handling and delivery of unfinished products from one manufacturing facility to another (or from the vendor to the first facility) does not constitute manufacturing, but instead constitutes the transportation or storage of raw materials. The transportation to or between each facility does not constitute a manufacturing activity and does not qualify for the partial exemption.

We disagree with your contention that the property used to transport the unfinished materials between the various plants is the same as the movement of materials along one continuous production line at a single geographic manufacturing location. In the Company's situation, the transportation necessary to transport the various unfinished, raw materials between the various plants consists of large trucks (or some other type of mobile transportation equipment) as well as loading and unloading equipment such as forklifts, containers, etc. We note that Regulation 1525.2(c)(10)(A) specifically includes belts, shafts, moving parts, operating structures, conveyance systems and assembly lines within the definition of property subject to the partial exemption. That section does not, however, list (nor contemplate) items such as trucks, mobile transportation equipment or other property used to store or transport unfinished goods between two distinct geographic locations. Moreover, Regulation 1532, Teleproduction Or Other Postproduction Service Equipment, was adopted after Regulation 1525.2 and is based on the same type of partial exemption from tax for teleproduction activities. That regulation specifically excludes vehicles (including those in or on which qualifying property is mounted or installed) from its definition of tangible personal property. (Reg. 1532(c)(6)(A).) We believe that the exclusion of vehicles also applies to the Regulation 1525.2 such that property used to transport unfinished materials to or between the Company's manufacturing facilities does not qualify for the partial exemption. This result equally applies where some of the Company's manufacturing facilities are located outside California.

"Issue #2: Display Shelving and Signage Purchased by Retailers

"Facts

"The company offers a co-operative advertising plan ('co-op plan'), which provides co-op advertising support for retail advertising of its products. The plan is offered on a proportionately equal basis to all retailers (e.g. x stores, y stores, etc.) in the United States. Retailer co-op funds are accrued by the Company, on behalf of the retailers, into a single trust fund from purchases made by retailers. Participating retailers realize co-op funds at a rate of 2% of qualifying purchases of the Company's clothing products. Qualifying media advertising, visual merchandising shelving, signage and other items are reimbursed from the collective fund at up to 50% of the cost price. Purchases of merchandising shelving and signage can occur by three methods:

"1) The retailer can arrange for the purchase and shipment of promotional shelving and signage to its own stores located in California. The shelving and signage manufacturer's invoice will note the retailer as the 'sold to' and 'ship to' entity. The retailer will receive the invoice from the shelving and signage manufacture, which will be paid by the retailer. The retailer will then submit the shelving and signage invoice to the Company for reimbursement of 50% of the cost price. The Company issues a check to the retailer for 50% of the cost price, which is paid from the retailer co-op trust fund. If a retailer submits claims for shelving and signage purchases, which are in excess of the amount of retailer co-op money accrued, the retailer will be billed for any deficiencies at the end of the co-op plan year.

"2) Same facts as number one except, the Company arranges for the purchase and shipment of promotional shelving and signage on behalf of the retailer customer. The Company will be noted as the 'sold to' and in some cases the 'ship to' entity on the invoice. However, the Company does not obtain possession of the shelving and signage; they are drop shipped directly to the retailer stores. The Company will pay the invoice which it receives from the shelving and signage manufacturer out of funds from the retailer co-op trust fund and will bill-back the retailer for the retailer's 50% share of the cost of the shelving and signage. The retailer's 50% payment back to the Company will be credited back to the retailer's co-op trust fund. If a retailer has insufficient co-op funds to pay for shelving and signage claims, the retailer will be billed for any deficiencies.

"3) Same facts as number two except, the Company does obtain temporary possession of the shelving and signage; however, they are subsequently transported to the retailer store locations. Again, the Company will pay the invoice which it receives from the shelving and signage manufacturer out of funds from the retailer co-op trust fund and will bill-back the retailer for the retailer's 50% share of the cost of the shelving and signage. The retailer's 50% payment will be credited back to the retailer's co-op trust fund. Again, if a retailer has insufficient co-op funds to pay for shelving and signage claims, the retailer will be billed for any deficiencies.

"In all three cases, payment from the retailer co-op trust fund cannot exceed the amount of retailer funds available. If a retailer submits claims for shelving and signage purchases, in excess of the amount of retailer co-op money accrued, then the retailer will be billed for any deficiencies. One retailer cannot use the funds of another retailer, the funds are non-transferable.

"..."

I understand you to ask how tax applies in each of the scenarios listed above.

As a starting point, California imposes a sales tax on the gross receipts from the retail sale of tangible personal property inside this state unless an exemption or exclusion otherwise applies. (Rev. & Tax. Code § 6051.) This tax is imposed on the retailer who may collect reimbursement from the customer if the contract of sale so provides. (Civ. Code § 1656.1; Reg. 1700(a).) When sales tax does not apply, such as when the sale occurs outside California, use tax is imposed on the sales price of property purchased from a retailer for use inside this state. (Rev. & Tax. Code §§ 620 1, 6401.) This tax is imposed on the purchaser. (Rev. & Tax. Code § 6202.) A retailer engaged in business in California must collect this tax from the purchaser and remit the tax to the Board. (Rev. & Tax. Code §§ 6203, 6204.)

In scenario one, the Company's customer itself purchases the display shelving and signage directly from a third party. We understand that these items are shipped directly to the Company's customer by the third party vendor and that the Company has no involvement in the transaction other than providing partial reimbursement to the customer from the co-op advertising funds earned by that customer. Under these facts, I agree that the Company has no obligation to collect, report or pay tax to this Agency with respect to the sale of the shelving and signage from the third party vendor to the Company's customer. Instead, the vendor must report and pay tax measured by its gross receipts where its sale to the Company's customer is subject to sales tax. The vendor must alternately collect use tax from the Company's customer and pay that amount to this Agency where the sale is subject to use tax (see subdivision (a)(2) of Reg. 1620; copy enclosed), and the vendor is a retailer engaged in business in this state pursuant to section 6203. The Company's customer is obligated to self report use tax measured by the sales price of the shelving and signage where the transaction is subject to use tax and the vendor is not a retailer engaged in business inside

this state. In any event, the taxable gross receipts or sales price from this transaction include all amounts received with respect to the sale of the shelving and signage. The amount of the co-op funds paid by the Company to its customer may not be excluded from the measure of the gross receipts or sales price.

In scenario two, the Company directly contracts with the vendor for the purchase of shelving and signage. This is a sale of tangible personal property to the Company. You did not, however, provide us with enough facts to conclusively determine whether the Company is making these purchases as the agent of its customer. (For example, you did not provide us with copies of any relevant agreements such as the co-op advertising agreement, a purchasing agency agreement (or any other agreement discussing the relationship between the parties), or provide a detailed enough description of the relationship between the Company and its customer.) Moreover, we assume that the Company is a retailer engaged in business inside this state pursuant to section 6203 (based on its purported manufacturing operations inside this state) such that the vendor is not regarded as the retailer when it drop ships the shelving and signage to the Company's customer. (See § 6007.³ If these assumptions are incorrect, our opinion would be different.) Based on these assumptions, we would regard the Company as the retailer of the shelving and signage where it is not in fact the purchasing agent of its customer. When this occurs, the Company may purchase the shelving and signage for resale. The Company's subsequent sale of these items to its customer is subject to tax. (The Company must report and pay tax measured by its gross receipts where the sale is subject to sales tax. The Company must alternately collect use tax from its customer and pay it to this Agency where the transaction is subject to use tax. (See Reg. 1620(a)(2).)) Where the Company is in fact the purchasing agent of its customer, tax applies to the sale of the items to the Company. Tax would not apply to the Company's subsequent transfer of the shelving and signage to its customer as the agent of the customer. In either event, however, the measure of tax includes all amounts received with respect to the sale of the shelving and signage. The amount of the co-op funds utilized by the Company toward the purchase of the shelving and signage that were earned by its customer may not be excluded from the measure of the gross receipts or sales price.

In scenario three, the Company actually obtains physical possession of the shelving and signage. The application of tax in this scenario appears to be the same as for scenario two. Where the Company is not the purchasing agent of its customer, the Company is the retailer of the shelving and signage and may purchase these items for resale from the vendor. The Company's subsequent sale to its customer is subject to tax and the Company must either report and pay tax measured by its gross receipts from that sale (where the sale is subject to sales tax), or alternately collect use tax from its customer and pay it to this Agency (where the sale is subject to use tax). (See Reg. 1620(a)(2).) Where the Company is in fact the purchasing agent of its customer, tax applies to the sale of the items to the Company, but not to the subsequent transfer of the items to the Company's customer. In either event, however, the measure of tax includes all amounts received with respect to the sale of the shelving and signage. The amount of the co-op funds utilized by the Company toward the purchase of the shelving and signage that were earned by its customer may not be excluded from the measure of the gross receipts or sales price.

We trust this answers your questions. If you have any further questions, please write again and include copies of all relevant agreements.

Sincerely,

Warren L. Astleford
Senior Tax Counsel

³ We further assume that the vendor who drop ships the property is located inside California.