

M e m o r a n d u m

To : Mr. Joseph D. Young, MIC:49 Date: May 31, 2002
Acting Headquarters Operations Manager

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Subject: Regulation 1620 - First Functional Use

This is in response to your memorandum dated April 11, 2002 in which you ask us to explain the first functional use test under Regulation 1620. This memorandum focuses on the provisions of Regulation 1620, and is based on the assumption that property discussed herein is purchased outside California, and that its use would not qualify for exemption or exclusion from tax under any provision other than Regulation 1620.

Subdivision (b)(3) of Regulation 1620 sets forth the basic rule that "property purchased outside of California which is brought into California is regarded as having been purchased for use in this state if the first functional use of the property is in California." That is, if property purchased outside California is first functionally used in this state, no further analysis is required: the property is regarded as having been purchased for use in this state, and tax applies to that use without regard to later use (whether inside California, outside California, in interstate commerce, or any combination thereof). On the other hand, if the property is first functionally used outside this state, the additional tests set forth in Regulation 1620 must be applied to determine if the property was purchased for use in this state, and if so, whether that use is exempt use in interstate commerce.

The determination of where the property is first functionally used is thus critical to the question of whether tax applies. Subdivision (b)(3) of Regulation 1620 guides this determination by specifying that "'functional use' means use for the purposes for which the property was designed." It is this language that has caused some confusion.

An aircraft is certainly designed to fly, and a truck is designed to be driven. Accordingly, it could be argued that a truck is first functionally used when it is first driven and an aircraft is first functionally used when it is first flown. On the other hand, trucks are almost always designed for some additional purpose, as are many aircraft. For example, while a Boeing 747 outfitted with 400

seats and all the galleys, instruments, etc. suitable for commercial passenger operation is designed to fly, it is designed to fly for a very specific purpose: to carry passengers. For purposes of the regulation's reference to the purpose for which the property was designed, is this 747 designed to fly, or designed to carry passengers in flight?

Test Applied Historically

The first step of the analysis is to determine what interpretation the Board has historically given this language. It is then necessary to determine whether any of the recent amendments to Regulation 1620 have intentionally, or unintentionally, changed the meaning or import of this language.

Business Taxes Annotation 325.0013.200 is based on a memorandum dated August 10, 1992 sent under cover memorandum from the Assistant Chief Counsel of the Sales Tax Section to the Assistant Chief Counsel of the Appeals Section, who had requested the position of the Sales Tax Section. Annotation 325.0013.200 states, in part:

"[I]f a vehicle or vessel is designed for commercial carriage, e.g., a bus, a tractor-trailer, or a sightseeing boat, the first functional use will be outside California if passengers are boarded or cargo is loaded onto the vehicle or vessel outside of California. If such vehicle or vessel is deadheaded into California, the first functional use will be in California unless the vehicle or vessel is brought to California to fulfill an existing lease or charter, or to pick up a specific load of cargo or group of passengers. The same applies to aircraft, though in some instances the purchase of such aircraft will be exempt under section 6366 or 6366.1.

"Vehicles, vessels and aircraft which are purchased for commercial purposes and used for commercial purposes are not 'functionally used' until used for the commercial purpose for which they were designed.

"With respect to vehicles, vessels, and aircraft designed for personal use, such as a passenger vehicle as defined in Vehicle Code section 465, a small motor boat, or a small plane, the first trip or flight into California is a functional use outside of California without regard to who drives or pilots the vehicle, vessel, or aircraft or to whether it is carrying passengers or cargo.

"Finally, regardless of what purpose the vehicle, vessel, or aircraft was designed for, the first functional use of such items will be in California if they are not brought into California under their own power and they have not otherwise been functionally used outside of California."

This interpretation was not new in 1992. Rather, this interpretation had been the long-standing interpretation of the Board on the determination of first functional use, having been

included in an annotation first published in 1974 and continuously applied since at least that time.¹ An example is the backup to Annotation 570.0500 (8/17/77). The annotation itself simply notes that when property is first functionally used in California, tax applies, but tax may or may not apply if the property is first functionally used outside the state. The backup reached this conclusion as part of its application of the interpretation noted above, explaining that commercial vehicles are regarded as being first used outside California when “they were dispatched to California to pick up specific loads.” The letter goes on to explain that “the mere transportation of property to a point where they are first placed in service does not amount to a functional use of the property in interstate commerce,” and that since the property in question was first functionally used in California, tax applied.²

In fact, this interpretation *pre-dated* the language in Regulation 1620 under review here. Prior to its amendment in 1978, subdivision (b)(1) of Regulation 1620 provided:

“Use tax applies with respect to any property purchased for storage, use or other consumption in this state the sale of which is exempt from sales tax under this regulation, except property held or stored in this state for sale in the regular course of business or subsequent use solely outside this state, and except property purchased for use in interstate and foreign commerce prior to its entry into this state, and thereafter used continuously in interstate and foreign commerce.”

This provision was interpreted as discussed above, that is, that property was regarded as purchased for use if first functionally used in this state for the purpose for which it was designed. However, the actual wording of the regulation was not as clear as the administrative interpretation the Board used to determine whether tangible personal property was purchased for storage, use, or other consumption in this state. In 1978, the Board decided to incorporate the administrative interpretation into the regulation by adding subdivision (b)(3) to read:

¹ This was the first of a four-part test Annotation 570.0430 (1/7/74, 3/23/84, 1/28/91) explained to determine whether a vehicle was purchased for use in California. Annotation 570.0430 was deleted from the Law Guide in 1999 because the Board thought that the fourth test was confusing, which related to continuous use in interstate commerce. When the annotation was deleted, the intent was to republish it with a more clear statement of the fourth test. However, the Board’s recent amendments to Regulation 1620 effectively rendered that test irrelevant, so the annotation was not republished, in part because the remaining interpretation from that deleted annotation was already included in annotation 325.0013.200. I mention the deleted annotation here to place the interpretation at issue here in proper historical context, that is, that the interpretation has been applied continuously since at least 1974.

² There is no difference in the determination of location of first functional use based on differing arguments for avoiding tax. If the property is first functionally used in California, we never reach the question of whether the taxpayer would otherwise avoid tax (e.g., the property was used or stored outside California one-half or more of the time during the first six months after entry into California or the property was thereafter used in continuous interstate commerce during that six-month period). The test for determining whether the property is first functionally used in California does not vary based on the later use of the property (e.g., in interstate commerce, or mostly outside California). However, as discussed below, a purchaser cannot contend one objective intent to overcome the ramifications of the manufacturer’s actual design of the property and then contend a conflicting objective intent for the remainder of the analysis in order to avoid tax.

"Property purchased outside of California which is brought into California is regarded as having been purchased for use in this state if the first functional use of the property is in California. When the property is first functionally used outside of California, the property will nevertheless be presumed to have been purchased for use in this state if it is brought into California within 90 days after its purchase, unless the property is used or stored outside of California one-half or more of the time during the six-month period immediately following its entry into this state. Prior out-of-state use not exceeding 90 days from the date of purchase to the date of entry into California is of a temporary nature and is not proof of an intent that the property was purchased for use elsewhere. Prior out-of-state use in excess of 90 days from the date of purchase to the date of entry into California, exclusive of any time of shipment to California, or time of storage for shipment to California, will be accepted as proof of an intent that the property was not purchased for use in California.

"For purposes of this subparagraph 'functional use' means use for the purposes for which the property was designed."

This amendment was adopted on September 28, 1978 (effective November 18, 1978). A review of the regulation file, the language of the amendment, and the annotations published before and after adoption of the 1978 amendment to Regulation 1620 confirms that annotation 325.0013.200 correctly reflects the intent of the regulatory language. I conclude that this remains the proper interpretation of what constitutes first functional use for purposes of applying Regulation 1620.

Applying this interpretation to the use of a Boeing 747 outfitted to carry 400 passengers, it is clear that the aircraft was designed to carry passengers. Accordingly, if it were first flown from outside California to Los Angeles Airport to await instructions to fly its first scheduled flight from that airport, it would be regarded as having been first functionally used in California. This would be true even though the aircraft first flew outside California on its deadhead journey into this state. On the other hand, if the aircraft were loaded with passengers on its first flight into California, it would be regarded as first functionally used outside the state. The aircraft would also be regarded as first functionally used outside California if it were dispatched, on its first flight into the state, to pick up a specific group of passengers.

Changes to Regulation 1620

It has been suggested that changes to Regulation 1620 during the last couple of years justifies departing from the interpretation discussed above. Subdivision (b)(3) of Regulation 1620 remained the same from the time of its adoption in 1978 until 1999. Subdivision (b)(3) was amended on November 19, 1999 (effective February 23, 2000) to add the concept that vehicles can be regarded as not purchased for use in California, even though brought into the state within 90 days of purchase and used in this state more than one-half of the time during the next six months, if one-half or more of the miles traveled by the vehicle during the six-month period are traveled in interstate

commerce.³ After stating the rules applicable to the use of vehicles purchased outside California, the regulation added 11 examples. The second and final paragraph of subdivision (b)(3) ("For purposes of this subparagraph 'functional use' means use for the purposes for which the property was designed") remained as the final paragraph of the subdivision (now separated from the first paragraph by the lengthy discussion specific to the use of vehicles) and continued to have the same meaning as before.

After having adopted special rules for vehicles, on May 4, 2000, the Board heard a petition for redetermination of use tax assessed against O--- I---, Inc. for its use of an aircraft in California. O--- I--- argued that, had the special rules for the use of vehicle applied to the use of aircraft, then O--- I--- would not have been regarded as having purchased its aircraft for use in California. However, as written, the special rule did not apply to its use of the aircraft and thus under the rules in effect at the time of its hearing, O--- I--- was regarded as having purchased the aircraft for use in California. Rather than decide the case under those existing rules, the Board's minutes shows that the Board ordered that the petition be "deferred and directed staff to amend Regulation 1620 to provide that the mileage rules applicable to buses and trucks used in interstate commerce should also be applied to aircraft and bring this amendment before the Board at the next Sacramento Board meeting."

Staff drafted amendments to Regulation 1620 in accordance with the Board's directions, and they were adopted on August 30, 2000 (effective December 17, 2000). As part of the drafting process, a new subdivision (b)(4) was created to include the prior special rules for vehicles along with the related new special rules for aircraft. The definition of functional use that had been the final paragraph of subdivision (b)(3) would now have been even farther from the term it defined and in a different subdivision. Thus, it was moved back into subdivision (b)(3). The person drafting the amendments concluded that the definition belonged directly after the regulation's first use of the term "functional use" rather than at the end of the subdivision, and thus moved it to that point, changing the language "for purposes of this subparagraph" to "for purposes of this regulation" to make clear that the definition applied to any use of the term "functional use" in the regulation.

It has been suggested that this movement of the definition, which had been at the end of the subdivision prior to its separation into two subdivisions, somehow signaled a change in the proper interpretation of this definition. The movement of this language was solely for purposes of clarification and simplification. The record is clear that the Board in no way intended that the interpretation of this phrase be changed, nor does the wording of the regulation itself support such a change. In fact, the change accomplished its purpose of making it more clear that "functional use" for purposes of Regulation 1620 means use for the purposes for which the property was designed, consistent with the Board's long-standing interpretation of what constitutes first functional use.

In summary, when the regulation simply provided that use tax applied if property was purchased for use in this state, the Board interpreted this to mean that property was purchased for use in this state, and tax applied, if the property was first functionally used in this state. The Board

³ The next amendment to the regulation clarified that the miles must be traveled in *commercial* interstate commerce.

further regarded functional use as meaning use for which the property was designed, so that there was a difference between the use of property designed for personal use versus property designed for commercial use. The Board then specifically amended Regulation 1620 to include this interpretation, and consistently interpreted "use for the purposes for which the property is designed" to be different for property designed for personal use versus property designed for commercial use. Finally, the changes to the regulation as a result of the addition of special rules for vehicles and aircraft (and thereafter for vessels) in no way requires, or permits, a change in interpretation.⁴

Applying the Rules

When a vehicle, vessel, or aircraft carries passengers or cargo prior to its entry into California, then it is not regarded as first functionally used in California (without regard to the meaning of the term "purposes for which the property was designed") and, depending on the other relevant facts, the property might qualify as not having been purchased for use in California. The same is true when a vehicle, vessel, or aircraft first enters California with the purpose of picking up a specific load of cargo or group of passengers. The problem in application arises when the property has not yet been used by the purchaser to carry cargo or passengers and is "deadheaded" (without cargo or passengers) into California to be ready for use. It is in this context where the meaning of "purposes for which the property was designed" makes a difference. If the vehicle, vessel, or aircraft is designed for personal use, the driving, sailing, or flying into California will be regarded as the property's first functional use, which will have commenced outside California. If the vehicle, vessel, or aircraft is designed for commercial use, the deadhead trip into this state will not be regarded as a functional use, and the first functional use will be regarded as occurring in California when the property carries its first load of cargo or group of passengers (or is dispatched to pick up the specific load of cargo or group of passengers).

Trucks (i.e., "big rigs") and buses are clearly designed for the purpose of carrying cargo or passengers. Thus, subject to the exception discussed below, trucks and buses are not functionally used simply because they are driven. Rather, they are first functionally used when they are first used for the purposes for which they are designed, that is, to carry cargo or passengers, or when driven pursuant to dispatch orders to pick up a specific load of cargo or group of passengers.

Automobiles, on the other hand, are designed for personal use. Automobiles generally seat four persons (comfortably) or five person (the three in the back less comfortably). Some automobiles seat as few as two persons and some larger automobiles can seat six persons comfortably. However, regular automobiles⁵ are designed for personal use. An extended discussion of this point is unnecessary considering that virtually all adults in this state have an automobile for personal use, which is just as intended by the vehicle manufacturers. This is true even though some regular automobiles are purchased by businesses for commercial purposes, whether to transport corporate officers to the airport

⁴ Since the information provided amply shows that the long-standing interpretation has not changed, there is no need to discuss the additional information in our records that further supports this conclusion.

⁵ By regular, I mean to exclude specialty vehicles. For example, a limousine is designed to carry passengers - it is a commercial vehicle. So too is a hearse.

or to deliver pizza. Since regular automobiles are designed for personal use, the act of driving them on public streets is a functional use, even if the driver carries no cargo or passengers. Thus, a person who purchases an automobile in New York and drives it, alone, to California has first functionally used the automobile in New York. This would be true without regard to any other facts (e.g., corporate purchaser for corporate business, deadheaded to California for standby purposes).

Between regular automobiles (designed for personal use) and buses and trucks (designed for carrying cargo or passengers) are vans. Some vans are essentially designed as replacements for regular cars, that is, for personal use. Vans designed for families, for example, are designed for personal use. They are first functionally used when used for the purposes for which they are designed, that is, to be driven on public streets. Other vans, however, are designed for business use. For example, vans designed for delivery of milk are designed for commercial use, though they are not seen often any more. Similarly, vans designed for delivery of bread and other commodities are designed for commercial use, not personal use. A UPS delivery van (or truck, or however else characterized) is a vehicle designed for commercial use.

Aircraft break down similarly to vehicles. Some aircraft are clearly designed for commercial use as are trucks and buses. Other aircraft are designed for personal use as are regular automobiles.

Aircraft manufactured by Boeing are designed for commercial purposes.⁶ Similar aircraft, such as the Airbus A300 and the Lockheed L-1011, are also designed for commercial purposes. On the other hand, we have long regarded standard small prop airplanes designed to carry two or four persons to be the equivalent of regular automobiles. These aircraft can certainly be used for commercial purposes, just as regular automobiles can, but they are aircraft that are specifically designed for "weekend pilots" and other personal use.⁷ A review of the aircraft designed and manufactured by two companies, Cessna and the New Piper Aircraft Company, is instructive.

Piper's web site shows seven models, the base model being the four-seat Warrior III and the top of the line being the six-seat Meridian. The entry level four-seat Warrior III is clearly designed for personal use. On the other hand, the price for the Meridian is more than ten times the price of the Warrior III, and the capacity is 50 percent more (in passenger load - six versus four, and standard useful load - 907 pounds versus 1,498 pounds). At first glance, it appears that the Meridian could have been designed for business use. However, on its web site, Piper describes the Meridian as a personal aircraft ("the most exciting personal aircraft ever") and describes a "step-up program" where a purchaser of a lower-priced Piper aircraft can trade it in on favorable terms towards "premium aircraft ownership." It appears that its entire line is available for this program, including the Meridian, which is consistent with the conclusion that Piper regards its entire line of aircraft to be designed for personal use.

⁶ Boeing also designs and manufactures military aircraft. This memorandum does not discuss these aircraft except to note that military aircraft are not designed for personal use, and for purposes of the first functional use test, the same rules applicable to commercial aircraft apply to military aircraft.

⁷ If such aircraft are modified for business purposes, such as outfitted for crop dusting, then the aircraft as outfitted would be designed for commercial use not personal use.

Cessna sells a variety of small aircraft, "Business Jets," "Utility Turbo-Props," and "Personal/Small Business Pistons." There are three basic models of prop aircraft in the Personal/Small Business category (each of which has a premium version), two of them seat four (the Skylane and the Skyhawk) and the top of the line seats six (the Stationair). Although Cessna obviously contemplates business purchasers of these aircraft, its description of these aircraft is aimed towards personal use.

Cessna has seven models in its Business Jet line. The smallest one is the Citation CJ1 which seats four passengers facing each other, and includes an additional side-facing jump seat, along with the pilots. The description for this jet aircraft, as well as the larger ones, makes it clear that these aircraft are designed and sold for business purposes, not personal purposes. Similarly, Cessna's description of its Utility Turbo-Prop line makes it clear that these aircraft are designed and sold for business purposes. These aircraft are offered for various business purposes, such as for freight, utility, or airline use. In the latter configuration, the aircraft might seat eight passengers, along with a pilot and co-pilot. As explained on Cessna's web site, "The aircraft can make a profit with less than four passengers." When in the airline configuration, although this prop aircraft has but ten seats, it is clearly designed for business purposes.

A review of these two major manufacturers of small aircraft is a useful guide for applying the rules discussed above. Jets are not designed and sold for personal use. The substantially greater cost in comparison to a similar size prop aircraft appears to be a significant reason that jet manufacturers design and market them for business use (the added difficulty of acquiring a license to fly a jet may also be a factor). Except as discussed below, we conclude that jets are designed and sold for business purposes, not for personal use. (A review of the web sites of other manufacturers of small jets is consistent with this conclusion.)

With respect to small prop aircraft, a review of the current manufacturers indicates that our previous rule of thumb, that a regular two or four seat prop airplane is designed for personal use, should be expanded to cover standard prop aircraft with up to six seats (i.e., two seats up front for pilot and co-pilot and up to four passenger seats) since today, aircraft designed for personal use are outfitted with up to six seats.

Finally, we have the remaining aircraft. Except for standard configuration prop aircraft with up to six seats, we believe that other aircraft are designed for business purposes. For example, the Cessna mentioned above with seating for eight passengers is designed for business purposes. An aircraft outfitted for some other special purpose, such as to crop dust or to carry freight, is also designed for business purposes.

There are two exceptions to the rules discussed above. Although we have explained the bright-line test where all prop aircraft with more than six seats, all prop aircraft specially outfitted for business purposes, and all jets are regarded as designed for business purposes, it is possible in a specific circumstance that a person may be able to provide sufficient information to show that a particular aircraft was actually designed for personal use. For us to reach such a conclusion, the information from the manufacturer must establish that the aircraft was actually designed and sold for personal use. If we

were to reach such a conclusion for a particular aircraft in a particular case, it would have global application and we would have to apply that same conclusion in *all* cases involving that particular aircraft in that particular configuration. I anticipate that it will be very rare that we would conclude that a jet or a prop aircraft with more than six seats was designed for personal use, but it is possible.

The other exception is based on the objective intent of the purchaser. Even if the aircraft is designed by the manufacturer for business purposes to carry freight or passengers, a particular person may purchase such business aircraft for personal use. When such is the case, we believe that it is appropriate to apply the rules for personal aircraft rather than business aircraft. The purchaser has the burden of proving that an aircraft designed for business use was actually purchased for personal use. So, for example, if a wealthy couple establishes that they purchased a small jet (and perhaps placed a jet pilot on retainer) for the purpose of flying themselves for personal purposes, we would regard them as having first functionally used the aircraft when they first fly the aircraft, without regard to the purpose of that first flight.

Finally, in light of the recent amendments to Regulation 1620, it is important to discuss the interaction between the exception just noted and one method of establishing that property is not purchased for use in California. If property is purchased outside California, first functionally used outside California, and then brought into this state within ninety days, the property is presumed to have been purchased for use in this state unless the purchaser overcomes that burden. The purchaser may overcome this presumption under the long-standing rule that the property was used or stored outside California one-half or more of the time during the first six months after the property first enters California. The Board has also added an alternative method to overcome the presumption for vehicles, vessels, and aircraft: the purchaser can overcome the presumption for vehicles "if one-half or more of the miles traveled by the vehicle during the six-month period immediately following its entry into this state are commercial miles traveled in interstate or foreign commerce," for vessels "if one-half or more of the nautical miles traveled by the vessel during the six-month period immediately following its entry into the state are commercial miles traveled in interstate or foreign commerce," and for aircraft "if one-half or more of the flight time traveled by the aircraft during the six-month period immediately following its entry into the state is commercial flight time traveled in interstate or foreign commerce." "Commercial" for these purposes is defined to apply to business uses and excludes personal use (though the business use does not have to be for profit). (Reg. 1620(b)(4)(B).)

A person who purchases a vehicle, vessel, or aircraft for both personal and business purposes may overcome the presumption under these new rules by establishing that the vehicle, vessel, or aircraft was purchased primarily for business purposes, specifically business (commercial) purposes in interstate commerce. Of course, we do not reach this issue if the property is first functionally used in this state. When the purchaser deadheads the vehicle, vessel, or aircraft into California to await instructions, the resolution of whether the property is first functionally used in this state depends on whether the property is designed for business use (first functionally used in California) or personal use (first functionally used outside California). That is, such a purchaser will be regarded as having purchased the property in California and will owe tax (without further analysis) unless the purchased vehicle, vessel, or aircraft was designed for personal use. As discussed above, in this type of

situation, if the property in question is a Cessna Meridian, we will accept that the property was first functionally used outside California. This is true without regard to the purchaser's intent as to how the aircraft will be used since the Meridian is designed for personal use and is regarded as first functionally used when the purchaser first flies it. Again, the determination of whether property is actually designed for personal or business use is dependent on the design of the property, and not the purchaser's intent.

Applying the basic rule just mentioned, we would never regard a jet or prop aircraft of more than six seats as having been functionally used simply because it was flown. However, as also discussed previously, if the purchaser establishes that he or she purchased a business vehicle, vessel, or aircraft for personal use, we will regard the deadhead journey into California as a functional use. However, when the purchaser seeks to overcome the presumption that the property was purchased for use in this state by arguing that the property was used commercially more than one-half the miles or flight time (as applicable), the person is necessarily contending that the property was purchased for business, and not personal, use. Accordingly, a person who purchases a vehicle, vessel, or aircraft designed for business use cannot successfully contend that the property was purchased for personal use for the first functional use tax and also make the conflicting argument that the very same property was purchased for the primary purpose of business use in interstate commerce. These contentions are mutually inconsistent. That is, if a person prevails on the argument that the property purchased to use primarily in commercial interstate commerce, that necessarily means that the primary purpose was not to use the property for personal purposes. This, in turn, means that the purchaser of property designed for business purposes and primarily used for business purposes cannot overcome the regulatory language that says we look to the purposes for which the property is designed.

In summary, we have applied the same basic rules to determine the place of first functional use for more than 25 years, and we should continue to apply the same rules. I hope the detailed explanation set forth above provides you the information you require. If, however, you have further questions, please let us know.

TWB:ljt

cc: Mr. Jefferson Vest (MIC:85)
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