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# California's New Partial Tax Exemption for Manufacturing and Research & Development

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**Tax Base**

A.B. 93 and S.B. 90, new partial sales and use tax exemptions, recently became available in California. Taxpayers in the state can now save approximately \$8 million annually if they are involved in manufacturing or research and development activities. In this article, authors Karri Rozario and Hal S. Kessler give an overview of the new partial exemption and discuss key definitions within it.

## California's New Partial Tax Exemption For Manufacturing and Research & Development



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Starting July 1, 2014, a significant new *partial* sales and use tax exemption for certain manufacturing or research and development equipment purchases became available in California.<sup>1</sup> AB 93 and SB 90 mark the California legislature's first effort to grant an exemption to a taxpayer who only performs research and development in the state. Previous exemptions required that the taxpayer be a manufacturer to make qualifying exempt purchases.<sup>2</sup> Taxpayers involved in manufacturing or research and development activities in California can now potentially reduce their California sales and use tax liability by more than \$8 million annu-

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<sup>1</sup> California Revenue & Taxation Code ("CRTC") §6377.1 (amended by 2013 CA S.B. 90 and 2013 CA A.B. 93).

<sup>2</sup> CAL. STATE Bd. OF EQUALIZATION, Operations Memo No: 1190 (Revised July 30, 2014), <http://www.boe.ca.gov/transparency/opsmemos/OM-1190.pdf>.

ally.

Currently, the California state sales and use tax rate is 7.5 percent.<sup>3</sup> District taxes may be added to the state sales and use tax rate. Beginning July 1, 2014, the new partial exemption lowered the levied statewide sales and use tax rate on eligible purchases or leases by 4.1875 percentage points.<sup>4</sup>

On July 17, 2014, the State Board of Equalization (BOE) approved California Code of Regulations (CCR) § 1525.4,<sup>5</sup> which was approved by the Office of Administrative Law (“OAL”) on September 25, 2014.<sup>6</sup> The new statute and final regulation contain several key definitions, specifically: “qualified person,” “establishment,” “primarily engaged,” and “qualified tangible personal property.” In addition to considering each of these definitions, this article will address the new partial exemption and final regulation,<sup>7</sup> and provide observations regarding application of the exemption.

## Qualified Person

The statute defines a qualified person to be a person “primarily engaged in those lines of business described in Codes 3111 to 3399, inclusive, 541711 and 541712 of the North American Industrial Classification System (NAICS) published by the United States Office of Management and Budget (OMB) 2012 edition.”<sup>8</sup>

NAICS codes classify different business establishments for federal statistical purposes.<sup>9</sup> Various agencies collect, analyze and publish statistical data on the U.S. economy using NAICS codes. Formerly known as Standard Industrial Classification codes, the NAICS code is a two through six-digit hierarchical classification system, offering five levels of detail. The first two digits designate the economic sector, the third digit designates the subsector, the fourth digit designates the industry group, the fifth digit designates the industry, and the sixth digit is country specific. A complete and valid NAICS code contains six digits.

For purposes of the partial tax exemption, a business’ NAICS code need only contain the first four digits of the specified industry line NAICS codes identifying a qualifying manufacturing activity. For manufacturing activities that do not have a specific six-digit NAICS

code, qualification based on the broader four-digit industry group affords greater flexibility to still qualify for the partial exemption.<sup>10</sup>

**Entity Versus Establishment.** A significant element contained in the regulation is the ability to qualify at either the entity or the establishment level.<sup>11</sup> As defined in the regulation:

“Establishment” includes multiple or single physical locations (including any portion or portions thereof), and those locations or combinations of locations (including any portion or portions thereof) designated as a “cost center” or “economic unit” by the taxpayer, where a qualified activity is performed, and for which the taxpayer maintains separate books and records that reflect revenue, costs, number of employees, wages or salaries, property and equipment, job costing, or other financial data pertaining to the qualified activity.<sup>12</sup>

This definition is consistent with the definition contained in the prior partial exemption, CRTC §6377 for new manufacturers which ended in 2002, and the partial exemption for Teleproduction and Other Post Production activities, CRTC §6378.

Qualification at the establishment level may allow taxpayers not normally considered a manufacturer or a research and development company overall to potentially qualify for the partial exemption. When analyzing a possibly qualifying company at the establishment level, only the establishment performing the qualifying activities has to be “primarily engaged.”<sup>13</sup>

**Primarily Engaged.** For purposes of the primarily engaged test, the establishment must derive 50 percent or more of gross revenue (including inter-company and intra-company charges) from, or expends 50 percent or more of operating expenses in a qualifying line of business. Alternatively, an establishment is “primarily engaged” if, in the prior financial year, it allocates, assigns or derives 50 percent or more of the following to a qualifying line of business: (1) employee salaries and wages, (2) value of production, or (3) number of employees based on a full-time equivalency.<sup>14</sup>

The primarily engaged test is important because it permits taxpayers that may not otherwise qualify strictly on a revenue basis to qualify based on the activities performed.<sup>15</sup> For example, a research and development company that would otherwise fail to qualify for the exemption based on gross revenues can now qualify if 50 percent or more of the company’s operating expenses are related to qualifying research and development activities.

The regulation also includes a measurement tool for non-profit and government entities that may be performing qualifying activities but may not have traditional revenue and expense streams.<sup>16</sup> For example, a

<sup>3</sup> CAL. STATE BD. OF EQUALIZATION, California City & County Sales & Use Tax Rates, <http://www.boe.ca.gov/sutax/pam71.htm>.

<sup>4</sup> The partial exemption will decrease by 0.25 percent to from 4.1875 percent to 3.9375 percent when the State’s Fiscal Recovery Fund pays off certain Economic Recovery Bonds authorized in 2004.

<sup>5</sup> *Manufacturing and Research & Development Equipment: Hearing on Regulation 1525.4 before the Cal. Bd. of Equalization* (July 17, 2014), [http://www.boe.ca.gov/meetings/transcripts/2014\\_07\\_17F1.txt](http://www.boe.ca.gov/meetings/transcripts/2014_07_17F1.txt).

<sup>6</sup> CAL. STATE BD. OF EQUALIZATION, *Regulation 1525.4 OAL approval*, <http://www.boe.ca.gov/serp.html?q=regulation+1525.4&cx=001779225245372747843%3A3ekb7ulvxre&cof=FORID%3A10&ie=UTF-8>.

<sup>7</sup> CAL. STATE BD. OF EQUALIZATION, MANUFACTURING AND RESEARCH & DEVELOPMENT EXEMPTION, [http://www.boe.ca.gov/sutax/manufacturing\\_exemptions.htm](http://www.boe.ca.gov/sutax/manufacturing_exemptions.htm) (last visited Aug. 20, 2014).

<sup>8</sup> CRTC. Code §6377.1(a)(6)(A).

<sup>9</sup> U.S. Census Bureau, North American Industry Classification System – Introduction to NAICS, <http://www.census.gov/eos/www/naics/>.

<sup>10</sup> CCR. tit. 18, §1525.4(b)(8)(A), available at [http://www.boe.ca.gov/regs/pdf/Reg1525\\_4\\_Final\\_Text\\_2014.pdf](http://www.boe.ca.gov/regs/pdf/Reg1525_4_Final_Text_2014.pdf).

<sup>11</sup> *Id.*

<sup>12</sup> *Id.*

<sup>13</sup> *Id.*

<sup>14</sup> *Id.*

<sup>15</sup> See *Cal. State Bd. of Equalization*, Operations Memo No: 1190 (Revised July 30, 2014), <http://www.boe.ca.gov/transparency/opsmemos/OM-1190.pdf>.

<sup>16</sup> CCR. tit. 18, §1525.4(b)(8)(A)(1).

nonprofit that receives funds for medical research may qualify as either an entity or establishment primarily engaged in qualified research activities if 50 percent or more of the gross revenue from the funds is allocated to the entity or establishment performing the qualifying activities.

**Limitations.** The new partial exemption excludes certain industry groups when they are required to apportion income under the California apportionment regulation CCR §25128.<sup>17</sup> The three main industry groups which may be affected are: 1) Finance and Banking, 2) Agricultural and 3) Oil and Gas.<sup>18</sup> CCR §25128 provides for a gross receipts test that is applied annually when filing a California Franchise or Income Tax Return.<sup>19</sup> Meeting the requirements of CCR §25128 will preclude an entity from qualification as a qualified person and the partial exemption may not be claimed.

One interesting question is whether a taxpayer can qualify for one year, but then not qualify the next (or vice versa) based upon the gross receipts test of CCR §25128.<sup>20</sup> In general, the answer is yes as it is a facts and circumstances test that is applied each year. The regulation states that if the taxpayer does not qualify as being primarily engaged for the financial year preceding the purchase, they will look to the one year period following the purchase of qualified tangible personal property.<sup>21</sup> This creates challenges in implementing the partial exemption and may require that a taxpayer wait and file refund claims after they have done the analysis to determine if they fall outside the scope of CCR §25128.

Another limitation of the new partial exemption is that a qualified person has a \$200 million annual cap on qualified purchases.<sup>22</sup> A qualified person who is required to file a combined report, under CCR §25101, will have the \$200 million annual cap applied to the combined group.<sup>23</sup> This limitation will require members of a combined group with more than one qualifying person to track and monitor the aggregate amount of qualified purchases for the combined group to ensure the group does not exceed the \$200 million cap. Non-profit organizations and government agencies are excluded from the combined reporting regulation.

**Contractors.** Generally, a construction contractor is a consumer and owes sales and use tax on the purchase of materials. Additionally as a consumer, a construction contractor would be precluded from purchasing materials exempt from sales and use tax unless the contractor was deemed to be a retailer of materials pursuant to CCR §1521. However, a construction contractor may qualify for the partial exemption if it is engaged to furnish and install qualified tangible personal property for a qualified person.<sup>24</sup> A special exemption certificate, BOE-230-MC,<sup>25</sup> may be issued by the contractor to its

vendors for qualified tangible personal property being purchased on behalf of a qualified person.<sup>26</sup> It should be noted that the general exemption certificate, BOE-230-M,<sup>27</sup> applicable to everything except construction contracts, differs from the construction contractors partial exemption certificate.<sup>28</sup>

The qualified tangible personal property that is furnished and installed as part of a construction contract is considered purchased by the qualified person for purposes of the \$200 million annual cap.<sup>29</sup> Therefore, it is recommended that construction contractors provide a list to the qualified person of the qualified tangible personal property and the cost of such property for purposes of the \$200 million annual cap.

A construction contractor itself may also be a qualified person if it performs a qualified activity.<sup>30</sup> For example, a company that makes and installs concrete as part of a construction contract may be considered both a qualified manufacturer for the concrete manufacturing activities, and a construction contractor for installing qualified materials for an unrelated third party who is a qualified person. In this example, it is recommended that the concrete company separately track qualified purchases made for its own manufacturing activities as well as provide a list of qualified tangible personal property installed on behalf of the qualified person relative to the \$200 million dollar annual cap for each qualified person.

## Qualified Tangible Personal Property

Qualified tangible personal property is tangible personal property with a useful life of one or more years that is used "primarily" or at least 50 percent of the time in a qualified activity.<sup>31</sup> Qualified tangible personal property includes tangible personal property that is directly used in any stage of the manufacturing, processing, refining, fabricating or recycling of tangible personal property. With some limitations, property used in research and development and used to maintain, repair, measure and test qualified tangible personal property and certain special purpose buildings also qualifies.<sup>32</sup>

Qualified tangible personal property does not include the following: consumable supplies with a useful life of less than one year, furniture, inventory, equipment used in the extraction process, equipment used to store finished goods until the manufacturing process completes, and property used primarily in administration, general management or marketing.<sup>33</sup>

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Manufacturing, Research and Development Equipment, *available at* <http://www.boe.ca.gov/pdf/boe230mc.pdf>.

<sup>26</sup> CCR. tit. 18, §1525.4(c)(1).

<sup>27</sup> CAL. STATE BD. OF EQUALIZATION, FORM BOE-230-M (5-14) Construction Contracts – Partial Exemption Certificate for Manufacturing, Research and Development Equipment, *available at* <http://www.boe.ca.gov/pdf/boe230m.pdf>.

<sup>28</sup> CAL. STATE BD. OF EQUALIZATION, Operations Memo – Partial Exemption for Manufacturing and Research & Development Equipment 2-3 (Revised July 30, 2014), *available at* <http://www.boe.ca.gov/transparency/opsmemos/OM-1190.pdf>.

<sup>29</sup> CCR.tit. 18, §1525.4(g)(2).

<sup>30</sup> *Id.*

<sup>31</sup> CRTC §6377.1(a)(3).

<sup>32</sup> CRTC §6377.1(a).

<sup>33</sup> CRTC §6377.1(a)(7)(B).

<sup>17</sup> CCR. tit. 18, §1525.4(b)(8)(B).

<sup>18</sup> *Id.*

<sup>19</sup> See CRTC §25128.

<sup>20</sup> CCR.tit. 18, §1525.4(b)(8)(A)(1).

<sup>21</sup> *Id.*

<sup>22</sup> CCR. tit. 18, §1525.4(d)(1).

<sup>23</sup> *Id.*

<sup>24</sup> CRTC §6377.1(a)(4).

<sup>25</sup> CAL. STATE BD. OF EQUALIZATION, FORM BOE-230-MC (5-14) Construction Contracts – Partial Exemption Certificate for

**Special Purpose Buildings.** Special purpose buildings and foundations used as an integral part of the manufacturing, processing, refining, fabricating or recycling process, or that constitute a research or storage facility used during those processes are specifically included in the definition of qualified tangible personal property. A special purpose building is defined as a building and the underlying foundation “that is specifically designed and constructed or reconstructed for the installation, operation and use of specific machinery and equipment with a special purpose” and “the construction or reconstruction of which is specifically designed and used exclusively for the specified purposes as set forth in subdivision (a) (the qualified purpose).”<sup>34</sup> The materials and fixtures incorporated into the special purpose buildings are deemed qualified tangible personal property. A special purpose building is considered used as an integral part if “the special purpose building or foundation is used directly in the activity qualifying for the partial exemption from sales and use tax and is essential to the completeness of that activity.”<sup>35</sup> Structures that would most commonly qualify as a special purpose building include, but are not limited to, clean rooms, spray booths, laboratories, and buildings that control for specific environmental factors or operating conditions which are a necessary part of the qualified activities.<sup>36</sup>

**Useful Life.** Tangible personal property that the qualified person treats as having a useful life of one or more years for state income or franchise tax purposes shall be deemed to have a useful life of one or more years for purposes of this regulation.<sup>37</sup> The BOE’s current position with respect to useful life for taxpayers who file a franchise or income tax return is that they must treat the qualified tangible personal property as depreciable property in order to qualify.

The BOE has not addressed how property will be viewed if the taxpayer is not required to file a franchise or income tax return and/or if the property is under an operating lease with a term of one or more years. (Leased property, as discussed below may also qualify for the partial exemption.) Under this situation, the BOE has informally indicated they would look to other documentation and support, such as Generally Accepted Accounting Principles and how the qualified person has treated the qualified tangible personal property for book purposes. Additionally, if an audit was to occur two years after the equipment was purchased and the equipment was still in use in a qualifying activity, a position may exist that the equipment has likely met the useful life test.

**Leased Property.** Leased machinery and equipment can also qualify for the partial exemption. Leased tangible personal property must meet the same requirements as purchased qualified tangible personal property. Additionally, the lease must be defined as a continuing sale and continuing purchase pursuant to CCR

§1660, “Leases of tangible personal property.”<sup>38</sup> The statute and regulation are silent as to whether the type of lease (i.e., capital lease or operating lease).

Similar to purchased qualifying property, leased qualifying property is required to remain in qualified use for at least 12 months. The 12-month period for leased qualified tangible personal property begins July 1, 2014, or later, depending on when the lease was executed or when the property was placed into qualified use. The lease payments will continue to be eligible for the partial exemption provided that the property remains qualified tangible personal property. The qualified person lessee will need to issue a partial exemption certificate to the lessor for the qualified tangible personal property to obtain the exemption.

The regulations also address a lease of qualifying property entered into prior to the July 1, 2014, effective date. In that instance, lease payments made after July 1, 2014, for qualifying property qualify for the partial exemption.

**Compliance Considerations.** Compliance with the new partial sales and use tax exemption raises several significant considerations. The first is the implementation of the partial tax rate in a taxpayer’s current system and the second is to develop a mechanism to track expenditures for the \$200 million cap. The current statewide sales and use tax rate is 7.5 percent, however, district taxes may be added to this rate.<sup>39</sup> Thus, taking the partial exemption into account, the net state sales and use tax rate is 3.3125 percent (7.5 percent minus 4.1875 percent) plus any applicable district taxes.<sup>40</sup> While more sophisticated sales and use tax software should be able to accommodate the partial rate for purposes of self-accruing and reporting California use tax, certain software programs and systems may be challenged to accurately apply this partial rate.

Tracking the \$200 million cap may be less of an issue for taxpayers with modest expenditures for qualified tangible personal property or that file separate entity franchise or income tax returns. However, taxpayers with significant purchases and that file a combined franchise or income tax return will need to consider all the entities in the group that may be performing qualified activities and how best to avoid exceeding the \$200 million cap. A large combined group with numerous qualified persons may want to consider allocating the cap annually between the qualified persons so each member is aware of its portion of the budgeted amount. If as the end of a calendar year approaches the combined group has not reached the cap, a qualified person in the group can consider making additional qualified purchases or (if a qualified person paid tax on purchases in excess of its allocated portion) seeking refunds.

While the new partial exemption is certainly good news for California businesses that perform qualifying activities, it does come with some uncertainty, challenges and complexities. Although the BOE has provided some guidance by way of an Operations Memo

<sup>34</sup> CCR. tit. 18, §1525.4(b)(9)(A)4.(a).

<sup>35</sup> CCR. tit. 18, §1525.4(b)(9)(A)4.(f).

<sup>36</sup> See , Cal. State Bd. of Equalization, Manufacturing and Research & Development Exemption - Examples. [http://www.boe.ca.gov/sutax/manufacturing\\_exemptions.htm#Examples](http://www.boe.ca.gov/sutax/manufacturing_exemptions.htm#Examples) (last visited Sept. 1, 2014).

<sup>37</sup> CRTS §6377.1(b)(10).

<sup>38</sup> CCR.tit. 18, §1525.4(f).

<sup>39</sup> CAL. STATE BD. OF EQUALIZATION, California City & County Sales & Use Tax Rates, <http://www.boe.ca.gov/sutax/pam71.htm>.

<sup>40</sup> See footnote 4 above.

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dated July 18, 2014 and revised July 30, 2014,<sup>41</sup> promulgation of a more detailed interpretation (e.g., a Tax Bulletin) would be useful. Taxpayers should carefully consider whether they qualify under the regulation's multiple requirements as well as the implementation of a system which accurately captures the correct rate.

### **Conclusion**

Taxpayers previously excluded from prior tax exemptions should check if they are now eligible to re-

ceive benefits under the new law. Although many states have sales and use tax exemptions for manufacturing and/or research and development, California has enacted a unique scheme that is more complex than nearly any other state. Generally, a taxpayer should check if they qualify as a "qualified person" that may be purchasing or leasing "qualified tangible personal property" used within a "qualifying activity." While the BOE has stated that it will answer specific questions regarding the exemption, taxpayers are advised to consult with their tax professionals to explore and navigate this new and beneficial exemption.

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<sup>41</sup> See Cal. State Bd. of Equalization, Operations Memo No: 1190 (Revised July 30, 2014), <http://www.boe.ca.gov/transparency/opsmemos/OM-1190.pdf>.