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STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION

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March 2, 1995

Mr. REDACTED TEXT

BURTON W. OLIVER
Executive Director

Dear Mr. REDACTED TEXT:

Re: REDACTED TEXT Corporation

This is in response of your letter of November 9, 1994 regarding the application of sales and use tax to the furnishing and installing of a molten carbonate fuel cell (MCFC) into a REDACTED TEXT plant in California by your client, REDACTED TEXT Corporation (REDACTED TEXT).

I understand that pursuant to a Prime Contract (Contract) with the U.S. Department of Energy (DOE), REDACTED TEXT is presently assembling a 250-kilowatt MCFC demonstration stack and power plant (System) at the REDACTED TEXT Oil Company of California's (REDACTED TEXT) REDACTED TEXT Research Center in REDACTED TEXT, California (Center). I understand that the primary objective of the System is to demonstrate the operation and efficiency of MCFC technology, including fuel processing, process cooling, waste heat recovery, carbon dioxide recycling, and direct current (dc) to alternate current (ac) power conversion. In addition to the foregoing, a related purpose of the System is to allow industry representatives to observe and comprehend the effectiveness and performance of the environmentally friendly, decentralized MCFC stack and power plant.

I understand that steam is generated in the cathode recycling process, in excess of that required by the System, and that steam is exported to REDACTED TEXT's nearby cogeneration plant for monitoring and evaluation. Likewise, ac current produced by the System will be sent to REDACTED TEXT's electrical grid for monitoring and evaluation.

You state various components external to the MCFC stack will be fabricated and packaged on a Balance of Plant (BOP) skid by REDACTED TEXT's Services (REDACTED TEXT). REDACTED TEXT will provide the natural gas, plant air, instrument air, purge nitrogen, start-up power, a steam connection to its cogeneration facility, and a connection to REDACTED TEXT's electrical grid. I further understand that the fuel processor and head utilization components of the System vary significantly from the fuel processor and heat utilization components required for use in a commercial MCFC stack and power plant.

As noted above, the electricity and steam generated by the System will be transferred to REDACTED TEXT's electric grid or REDACTED TEXT's cogeneration facility for testing,

evaluation, and analysis. However, the REDACTED TEXT electrical grid and the REDACTED TEXT cogeneration plant are not dependent on the System for their continuous operation.

You state as follows:

1. When fabrication and assembly are completed the modular components of the MCFC stack and BOP will be placed on skids and transported to the Center by truck.
2. At the Center the MCFC stack and the BOP, as well as any other modular components, are assembled into a working system.
3. The MCFC stack and the BOP remain on the skids to which they are attached; however, the skids are bolted to a concrete pad and the various modular components are connected together.
4. The bolts used to secure the skids to the concrete pad are easily removed, and either the assembly or disassembly of all of the component parts of the MCFC stack and the BOP can be accomplished within a single day.

You indicate that REDACTED TEXT, under its Contract with the DOE, is responsible for, among other things, procuring all necessary machinery, equipment, and consumables used in fabricating and assembling the System. You state the relevant portion of the Contract with the DOE concerning changes in title provides as follows:

- "1. The Government shall retain title to all Government-furnished property.
- "2. Title to all property purchased by the Contractor for which the Contractor is entitled to be reimbursed as a direct item of cost under this contract shall pass to and vest in the Government upon the vendor's delivery of such property.
- "3. Title to all other property, the cost of which is reimbursable to the Contractor, shall pass to and vest in the Government upon -
 - (a) Issuance of the property for use in contract performance;
 - (b) Commencement of processing of the property or use in Contract performance; or
 - (c) Reimbursement of the cost of the property by the Government, whichever occurs first."

You state that REDACTED TEXT intends to operate the System at the REDACTED TEXT facility. The period of use envisioned can be extended; however, the System is neither designed nor intended by REDACTED TEXT to remain in place permanently. Further, under the terms of the Contract, the title to the component parts of the System will vest in the DOE long

before demonstration and testing are completed. As a result of which, the ultimate disposition of the System rests with the DOE. You state that the options available to the DOE include abandoning the System in place, moving the System to another test site, or returning the System to REDACTED TEXT for further testing, evaluation, and analysis. The System as you have described it is substantially similar to a common electric generator, although on a much larger scale and using a novel technology.

Revenue and Taxation Code section 6051 imposes a sales tax, computed as a percentage of gross receipts, upon all retailers for the privilege of selling tangible personal property at retail. Section 6006 defines "sale" as "(a) Any transfer of title or possession . . . of tangible personal property for a consideration" and section 6007 defines retail sale as "a sale for any purpose other than resale in the regular course of business." Hence, a sale of property in the form of tangible personal property is not a sale subject to the sales tax if the buyer plans to resell the property in the regular course of business. (Standard Oil Co. v. State Board of Equalization (1965) 232 Cal.App.2nd 91,95.)

When sales tax does not apply, use tax applies to the use of tangible personal property purchased from a retailer for use in California. (Rev. & Tax Code §§ 6201, 6401.) Thus, subdivision (a) of section 6094 provides: "If a purchaser who gives a resale certificate makes any use of the property other than the retention, demonstration, or display while holding it for sale in the regular course of business, the use shall be taxable to the purchaser...as of the time the property is first used by him or her..."

Regulation 1618 defines a "United States Government supply contract" as "a contract with the United States to furnish, or fabricate and furnish, tangible personal property...whereby title to tangible personal property purchased for use in fulfilling the contract passes to the United States before the contractor uses the property to perform the function or act for which the property was designed or manufactured. The term 'U.S. Government supply contract' does not include contracts to construct improvements on or to real property or the purchase of tangible personal property for use in fulfilling such contracts."

Section 6007.5 provides in pertinent part:

"A sale of tangible personal property to a contractor or subcontractor for use in the performance of contracts with the United States for the construction of improvements on or to real property in this State is a retail sale. The gross receipts from such a sale or the sales price of the property so sold shall be included in the measure of the taxes imposed by this part."

Section 6381 provides in pertinent part:

"There are exempted from the computation of the amount of the sales tax the gross receipts from the sale of any tangible personal property to the United States, its unincorporated agencies and instrumentalities."

Section 6384 provides in pertinent part:

"The tax imposed under this part shall apply to the gross receipts from the sale of any tangible personal property to contractors purchasing such property either as agents of the United States or for their own account and subsequent resale to the United States for use in the performance of contracts with the United States for the construction of improvements on or to real property in this state."

Sales and Use Tax Regulation 1521 discusses the application of tax to construction contracts for the improvement of real property. Subdivision (a)(1)(A)2 of the regulation defines "construction contract" to include contracts to:

"Erect, construct, alter or repair any fixed works such as 'atomic electric generating plant'."

On the other hand, subdivision (a)(1)(B)1 provides that "construction contract" does not include contracts to furnish and install machinery and equipment.

The term "fixture" is defined in Regulation 1521(a)(5) as follows:

"'Fixtures' means and includes items which are accessory to a building or other structure and do not lose their identity as accessories when installed. A list of typical items regarded as fixtures is set forth in Appendix B." (Electric generators are included in Appendix B as items regarded as fixtures.)

The term "machinery and equipment" is defined in Regulation 1521(a)(6) as:

"'Machinery and equipment' means and includes property intended to be used in the production, manufacturing or processing of tangible personal property, the performance of services or for other purposes (e.g., research, testing, experimentation) not essential to the fixed works, building, or structure itself, but which property incidentally may, on account of its nature be attached to the realty without losing its identity as a particular piece of machinery or equipment and, if attached, is readily removable without damage to the unit or to the realty. . . . A list of typical items regarded as machinery and equipment together with a list of items not regarded as machinery and equipment is set forth in Appendix C." (Items regarded as fixtures are not machinery and equipment.)

Sales and Use tax Regulation 1521(b)(1) provides that the application of tax to a United States Construction Contractor is as follows:

"(A) **Materials and Fixtures.** United States construction contractors are consumers of materials and fixtures which they furnish and install in the performance of contracts with the United States Government. Either the sales tax or the use tax applies with respect to sales of tangible personal property (including materials, fixtures, supplies and equipment) to contractors for use in the performance of such contracts with the United States for the construction of improvements on or to real property in this state.

"(B) **Machinery and Equipment.** United States contractors are consumers of machinery and equipment furnished in connection with the performance of a construction contract with the United States. Tax does not apply to the sales of machinery and equipment to United States contractors or subcontractors, provided title to the property passes to the United States before the contractor makes any use of it. Such sales are sales for resale, and the purchasing contractor may issue a resale certificate. A contractor who uses the machinery or equipment before title passes to the United States is the consumer of that machinery or equipment and either sales tax or use tax applies with respect to the sale or the use by the contractor."

You have stated under the terms of the contract, title to all tangible personal property acquired by REDACTED TEXT and REDACTED TEXT for use in performance of the contract passes to and vests in the DOE upon:

1. Issuance of the property for use in contract performance;
2. Commencement of processing of the property or use in contract performance; or
3. Reimbursement of the cost of the property by the Government whichever first occurs.

As above stated, a construction contract does not include a contract to furnish and install only machinery and equipment. Such a contract would fall in the category of a supply contract. Thus, if REDACTED TEXT is furnishing and installing only machinery and equipment, REDACTED TEXT will be regarded as making an exempt sale of tangible personal property to the DOE.

However, if the property furnished and installed by REDACTED TEXT constitute improvements to real property (i.e., materials and fixtures), REDACTED TEXT would be performing a United States construction contract. If so, REDACTED TEXT will be regarded as the consumer of any materials and fixtures it furnishes and installs, and tax will apply to the sale of such property to REDACTED TEXT.

The court in C.R. Fedrick, Inc. v. State Board of Equalization, (1988) 204 Cal.App.3rd 252, 259-260, construed the term "machinery and equipment" as defined in Regulation 1521(a)(6) as excluding "fixtures" within the meaning of that term under section 105. The court in Allstate v. State Board of Equalization (1984) 161 Cal.App.3rd 885-886 offered various guidelines to be used in making classification decisions. The court determined that where items might otherwise be classified as personalty but are attached to and designed for use in conjunction with items that are indisputably fixtures, the entire unit is deemed to be a fixture.

The concept of permanent affixation to realty does not imply attachment in perpetuity. "It is sufficient if the article shall appear to be intended to remain where fastened until worn out, until the purpose to which the realty is devoted has been accomplished or until the article is superseded by another article more suited for the purpose." (San Diego T&S Bank v. San Diego (1940) 16

Cal.2nd at 151.) You stated that the property in question was intended to remain in place throughout the testing period whereupon the DOE would make a decision whether to leave it there for an indefinite period, to scrap it, or in any other way deal with the item. Thus, it is possible that the equipment could remain in place until worn out or superseded.

Notwithstanding the estimate of REDACTED TEXT that removal of the system will only require approximately one day's work, the system is bolted to the real estate. In addition, the generator is attached to the plant's steam cogeneration facility and its electrical grid. The MCFC does not produce, manufacture or process other tangible personal property as required in Regulation 1521 in order to be considered machinery and equipment. Instead, the MCFC is designed for and is being used in conjunction with items that are fixtures, i.e., the steam cogeneration facility and the plant's electrical grid. The system is a type of electrical generator which is specifically listed as a fixture in Appendix B of Regulation 1521. We conclude the MCFC is a fixture. REDACTED TEXT is the consumer of materials and fixtures which it furnishes and installs in the performance of its contract with the United States government and tax applies to the sale to, or use by, REDACTED TEXT of the tangible personal property it furnishes and installs pursuant to that contract. If you have any further questions, feel free to write again.

Yours very truly,

Anthony I. Picciano

Staff Counsel

AIP:es

cc: Out-of-State District