STATE OF CALIFORNIA

190.0461

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April 30, 2003

Mr. [S]
Sr. Vice President
[G]
XXX --- ---
--- ---. -- XXXXX

Re: [A]
Permit No. S- --- --- - ------

Dear Mr. [S]:

This is in response to your January 27, 2003 letter asking how tax applies to certain transactions undertaken by your client. We apologize for the delay in our response.

You describe the general facts about your client as follows:

> "Our firm represents [A] (the 'client'), a licensed California contractor holding a general engineering contractors license, Sales and Use Tax permit no. XX-XXXXXX. The client owns a rock, sand, and gravel pit, as well as all the machinery to crush and screen the native rock, sand, and gravel into materials used in constructing roads, bridges and like structures."

You provide two scenarios relating to the above facts. We initially note that we have not been provided with copies of the agreements entered into by your client or a sample construction contract which is representative of the contracts entered into by the parties. Since these documents are critical in determining how tax applies to your client's transactions, we are only able to comment on how tax applies based upon your representations of the events that transpire between the parties and cannot give a definitive opinion on the application of tax to these transactions. It is also possible that our characterization of the transactions might be different upon our review of the contracts and related documentation between the parties. In addition, in order to respond to your questions, we have provided certain assumptions of fact where you did not provide sufficient facts for us to determine how tax applies in a particular scenario. In the

event the actual facts, conditions or situations surrounding the transactions are not as stated in your correspondence to, or assumed by, us our opinion below might be different.

DISCUSSION

As a starting point, California imposes a sales tax on a retailer's gross receipts from the retail sale of tangible personal property inside this state unless the sale is specifically exempted or excluded from taxation by statute. (Rev. & Tax. Code, § 6051.) This tax is imposed on the retailer who may collect reimbursement from its customer if the contract of sale so provides (Civ. Code, § 1656.1; Reg. 1700.) When sales tax does not apply, use tax is imposed on the sales price of property purchased from a retailer for the storage, use or other consumption of that property in California unless specifically exempted or excluded from taxation by statute. (Rev. & Tax. Code, §§ 6201, 6401.) A sale or purchase includes any transfer of title or possession, in any manner or by any means whatsoever, of tangible personal property for a consideration. (Rev. & Tax. Code, §§ 6006(a), 6010(a).)[1] Taxable gross receipts or sales price includes all amounts received with respect to the sale, with no deduction for the cost of the materials, service, or expense of the retailer passed on to the purchaser, unless there is a specific statutory exclusion. (Rev. & Tax. Code, §§ 6011, 6012.) Thus, unless a specific exclusion exists, expenses incurred by a retailer which are part of the retail sale of tangible personal property, such as fabrication,[2] are included in the taxable gross receipts or sales price, as are any other costs of the retailer which are passed on to the end customer.

The application of tax to activities undertaken by construction contractors is explained in Regulation 1521. Subdivision (a)(1)(A)1. of that regulation defines a construction contract to include lump sum and other contracts to erect, construct, alter, or repair any building or other structure or improvement on or to real property. However, a construction contract does not include the furnishing of tangible personal property under what is otherwise a construction contract if the person furnishing the property is not responsible under the construction contract for the final affixation or installation of the property furnished. (Reg. 1521(a)(1)(B)2.) A person who performs a construction contract is a construction contractor. (Reg. 1521(a)(2).)

Regulation 1521 also defines "materials" as that term applies to construction contracts. Materials consist of construction materials and components, and other tangible personal property incorporated into, attached or affixed to real property by a construction contractor, which when combined with other tangible personal property lose their identity to become an integral and inseparable part of the real property. (Reg. 1521(a)(4).) Appendix A to Regulation 1521 lists typical items regarded as materials and specifically includes gravel. This means that gravel as well as rock or other similar materials when incorporated into roadbeds lose their identity as

[1] A sale also includes the producing, fabricating, or processing of tangible personal property for a consideration for consumers who furnish either directly or indirectly the materials used in the producing, fabricating, or processing. (Rev. & Tax. Code, § 6006(b).)

[2] Subdivision (b) of Regulation 1526 defines fabricating to include any operation which results in the creation or production of tangible personal property or which is a step in a process resulting in the creation or production of tangible personal property.

tangible personal property and become an integral and inseparable part of real property and are therefore regarded as materials. "Fixtures," on the other hand, are defined as items which are accessory to a building or other structure and do not lose their identity as accessories when installed. (Reg. 1521(a)(5).) Appendix B to Regulation 1521 lists typical items regarded as fixtures.

Construction contractors are generally the consumers (as opposed to the retailers) of materials which they furnish and install in the performance of a construction contract. (Reg. 1521(b)(2)(A)1.) Either sales tax or use tax applies to the sale to, or use of the materials by the construction contractors. (*Id.*) However, when materials are not acquired by purchase (as that term is defined in Revenue and Taxation Code sections 6006(a) and 6010(a)), no use tax applies. Conversely, construction contractors other than United States construction contractors are the retailers of fixtures which they furnish and install in the performance of a construction contract. (Reg. 1521(b)(2)(B)1.) When a person does not perform a construction contract and instead merely installs tangible personal property owned by another, tax does not apply to his or her charges for installation. (Rev. & Tax. Code, §§ 6011(c)(3); 6012(c)(3).) With that background in mind, we now set forth each scenario followed by our response.

Scenario 1:

In this scenario, you ask whether your client would be liable for sales or use tax when:

> "The client enters into a contract to construct a highway in California with another party, other than the United States, and supplies and installs all the construction materials using its own rock, sand and gravel pit reserves (the 'RSG Materials'), labor and equipment. All of the RSG Materials are taken from land owned by the client. Sales tax has been paid to the suppliers for all other materials that are used to construct the highway."

We understand that your client enters into contracts[3] to improve real property by furnishing and spreading or laying gravel, rock, or other similar material that your client then levels, tamps and rolls. You indicate that your client is a licensed California contractor. We therefore assume that your client is located in California and performs all its work inside this state. Under these facts, your client's lump sum contracts to furnish and install materials such as gravel or rock that become an integral and inseparable part of a highway are construction contracts. (Reg. 1521(a)(1).) As such, the application of tax to your client's transaction is governed by Regulation 1521.

As noted above, we regard gravel, rock, or other similar tangible personal property as materials. As a construction contractor, your client is the consumer of materials it furnishes and installs in the performance of a construction contract, and either sales tax or use

[3] For purposes of this opinion, we assume all contracts that constitute a construction contract within the meaning of Regulation 1521(a)(1) are on a lump sum basis.

tax applies to the sale to, or use of the materials by your client. (Reg. 1521(b)(2)(A).) Your client owes tax or tax reimbursement on the material it purchases[4] as part of these contracts measured by the purchase price of such material, unless your client previously paid tax or tax reimbursement on its purchase of that material. In other words, the tax or tax reimbursement reported or paid is measured by the sales price to your client not your client's gross receipts from its sales to its customer.

Tax does not apply however to amounts related to the *crushing* of rock when your client crushes rock it excavates from its own gravel pit or purchases from a third party for use in performing a lump sum construction contract for its customer. The processing your client performs on its own rock is not part of the amounts your client may pay to acquire the rock. Consequently, the cost of crushing the rock done by your client to its own property is not subject to tax when your client thereafter consumes this rock in the performance of a construction contract.[5]

Scenario 2:

In this scenario, you ask whether your client or its "joint venture partner" is liable for any sales or use tax when:

> "The client and another contractor enter into a joint venture agreement, and as joint venturers contract to construct a highway in California with a third party, other than the United States. Under this contract, the joint venture is responsible for the completed highway. Under the terms of the joint venture agreement:
>
> "A. The client supplies construction materials for the contract using its RSG Materials, labor and equipment to produce the construction materials, but the joint venture partner ('JV Partner') using its labor and equipment installs the construction materials. The client does not sell the construction materials to the joint venture or its JV Partner, but rather contributes it to the joint venture. The same is true for the work supplied by the JV Partner. The joint venture will not own the equipment or employ the labor used by the JV Partner or the Client.

[4] Your client does not acquire the rock by purchase when it produces the rock by excavating its own gravel pit. Thus, use tax does not apply to the rock.

[5] On the other hand, when a subcontractor located in California crushes rock or gravel owned by your client, the subcontractor is performing taxable fabrication. (Reg. 1526(a).) The subcontractor is required to report and pay tax to this Agency measured by its charges and may collect tax reimbursement from your client if the contract of sale so provides. If your client thereafter uses its "fabricated" rock in the course of performing a lump sum construction contract, your client is the consumer of this rock and its charges to its customer pursuant to its construction contract are not subject to tax. (Reg. 1521(b)(2)(A).) That is, when your client furnishes and installs materials under a construction contract, sales or use tax applies to the sale of such materials to, or the use of those materials by your client (including charges for fabrication). However, where your client does not acquire materials by purchase, no use tax liability arises.

> "B. There is a division of the entire contract price, whereby, the client receives from the joint venture the agreed rates for the construction materials actually supplied by them and the JV Partner receives the balance; each of them, thus receives the portion of the contract price representing the agreed value of their respective contributions.
>
> "C. The client and the JV Partner are each only responsible for their portion of the contract, and they each are required to indemnify and hold the other harmless from all losses, liabilities and costs arising from its portion of the contract. However, as a matter of law, as joint venture partners, each of them will be liable for all liabilities of the joint venture (joint and several liability of joint venturers).
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> " . . . The client and the JV partner have paid or will pay sales tax to the dealers on the equipment when purchased and will pay sales tax on any rented equipment used."

You did not provide us with enough information to conclusively answer your questions. For example, it is unclear whether the parties have truly formed a joint venture. We have not been provided sufficient details of the agreement between your client and the JV Partner or additional explanations regarding the basis for structuring the transaction as you propose. Moreover, the application of tax to this type of a transaction would need to be reviewed on a case by case basis because the analysis is fact specific. Our opinion should therefore be considered only a general discussion as to how tax might apply and not a definitive response.

A joint venture is a "person" as that term is used in the Sales and Use Tax Law. (Rev. & Tax. Code, § 6005.) A true joint venture is identifiable by the following characteristics: it is a special combination of two or more persons without corporate or partnership designation, formed for the purpose of jointly seeking a profit in a specific venture, and for which purpose the persons combine their property, money, efforts, skills, or knowledge. There must be a community of interest and a sharing of profits and losses, and each venturer must have a right in some measure to direct the conduct of the business through a fiduciary relationship that must exist. If these tests are met, the relationship will be considered a joint venture rather than one of seller and buyer. (Sales and Use Tax Annot. 415.0093 (2/17/72); 40 Cal. Jur.3d, Joint Ventures, §§ 1-8, pp. 375-385.)

Under the Sales and Use Tax Law, sales tax does not apply to a transfer of property to a commencing entity (e.g., a joint venture) in exchange solely for an interest in that commencing entity. (Reg. 1595(b)(4).) However, tax applies if the transferor receives consideration such as cash, notes, or an assumption of indebtedness, and the transfer does not otherwise qualify for an exemption. (*Ibid.*)

You indicate that your client and the JV Partner will contribute construction materials and installation, respectively, to the joint venture. You also indicate your client will not sell the construction materials to the joint venture or the JV Partner. These statements appear inapposite in light of the fact that your client will be paid by the joint venture an amount, agreed to in advance, representing the value of the construction materials transferred by your client to the joint venture in accordance with the construction contract. In other words, it appears to us that your client and the JV Partner do not share in the profits and losses of a commencing joint enterprise and instead receive compensation for materials and services from the joint venture. Furthermore, we note that the joint venture appears to be responsible for the completed highway, but that your client is responsible for producing the construction materials and the JV Partner is responsible for the installation and that these parties indemnify and hold each other harmless from losses arising under the construction contract. These facts appear to indicate that the participation of your client and the JV Partner is limited to either providing construction materials or carrying on a particular activity (i.e., installation) as separate persons rather than for the purpose of engaging in a joint enterprise constituting a joint venture. In view of the foregoing, it does not appear to us that there is any community of interest as is evident in a true joint venture and that your client and the JV Partner instead direct their own conduct and do not maintain a fiduciary relationship. It therefore appears that your client and the JV Partner do not intend to form a true joint venture.

Despite the foregoing, (and without conceding the above point), we will nevertheless assume for the remainder of the opinion that your client and the JV Partner will form a new joint venture for the specific purpose of performing only one construction contract. We further assume that the joint venture contracts directly with the third party to improve real property when it constructs a highway and is thus a construction contractor.

As noted above, the transfer of tangible personal property to a commencing joint venture is not subject to tax when no consideration is received for the transfer other than an interest in the joint venture. (Reg. 1595(b)(4).) Thus, sales tax would not apply where your client is transferring the construction materials in exchange solely for an interest in a commencing joint venture between your client and the JV Partner.[6] Tax would apply where your client is regarded as transferring the construction materials to either the joint venture or the JV Partner for consideration. (*Ibid.*) Here, in the absence of reviewing all the relevant documentation, it is possible that your client will receive consideration at the time of transfer, that being the commitment by the joint venture to pay a specified amount concurrent with the joint venture's

[6] The transferor (e.g., your client) may however have a use tax liability. If the transfer constituting the contribution occurs inside this state, the transferor will be regarded as having used or consumed the property inside this state and will owe use tax measured by its purchase price of the property unless sales tax reimbursement or use tax was paid with respect to the transfer of the property to the transferor. Likewise, the transferee (e.g., construction contractor) may also be liable for use tax measured by its cost of the materials it uses in the performance of the construction contract unless sales tax reimbursement or use tax was paid with respect to the transfer of the materials to the transferee. However, neither the transferor nor the transferee would have any use tax liability where they do not acquire the tangible personal property by purchase (i.e., for no consideration). (See Sales and Use Tax Annot. 395.0004 (02/29/84).)

transfer of the construction materials to a third party. Regulation 1595(b)(4) does not provide a means by which to avoid tax when the transfer of property to a commencing entity in exchange for a membership interest also includes the simultaneous sale of that property. This means that whether or not a joint venture exists between your client and the JV Partner, it is possible that your client will be receiving consideration which constitutes a sale of tangible personal property to the joint venture that is subject to tax.

To the extent that your client is transferring the construction materials to the joint venture for consideration, such transfer is a sale for which your client is the retailer. (Reg. 1595(b)(4).) The gross receipts from that sale are measured by the consideration received by your client for the construction materials, including fabrication and excavation. (*Ibid.*) With respect to the JV Partner, while it transfers installation labor to the commencing joint venture, it does not appear to transfer any tangible personal property. As noted above, installation labor is not subject to tax. (Rev. & Tax. Code, §§ 6011(c)(3), 6012(c)(3).)

With respect to the equipment purchased by your client and/or the JV Partner for use in their respective businesses inside this state, tax applies measured by the sales price of the equipment sold to your client and/or the JV Partner, unless your client and/or the JV Partner previously paid tax or tax reimbursement on their purchase of the equipment. (See Civ. Code, § 1656.1; Rev. & Tax. Code, §§ 6201, 6401; see also Reg. 1521(b)(5).)

Last, we note you have identified your client as [A]. Only [A] may rely on this opinion under the provisions of Revenue and Taxation Code section 6596 and only to the extent you have provided us with sufficient and adequate information regarding the proposed transactions such that we are able to provide you with a conclusive opinion as to how tax applies. We also note that you do not identify the joint venture or the JV Partner. Our comments therefore concerning transactions by the joint venture or the JV Partner are only general comments and not written advice upon which the joint venture or the JV Partner may rely pursuant to Revenue and Taxation Code section 6596.

I hope this answers your question. If you have any further questions, please write again.

Sincerely,

Trecia M. Nienow
Senior Tax Counsel

TMN:bb