



STATE BOARD OF EQUALIZATION

1020 N STREET, SACRAMENTO, CALIFORNIA
(P.O. BOX 942879, SACRAMENTO, CALIFORNIA 94279-0001)
(916) 445-6450

WILLIAM K. BENNETT
First District, Kentfield

BRAD SHERMAN
Second District, Los Angeles

ERNEST J. DRONENBURG, JR.
Third District, San Diego

MATTHEW K. FONG
Fourth District, Los Angeles

GRAY DAVIS
Controller, Sacramento

September 16, 1992

BURTON W. OLIVER
Executive Director

Mr. [M]
Director, State and Local Taxes
[H]
--- ---, -- XXXXX

Re: S- -- XX-XXXXXX
Fixed-Price Construction Contract
Machinery & Equipment

Dear Mr. [M]:

I am writing this to answer your letter of July 10, 1992, to the Legal Division. You requested two rulings concerning the application 'of the fixed-price contract exemption from the recent increases in the sales and use tax rates to this transaction and also whether or not certain of the items listed in [H]'s contract are considered fixtures or machinery and equipment. We note that the Board staff cannot issue tax rulings; only the Board itself may do that. However, we can give you our opinion regarding the correct application of tax to a given set of facts.

The contract at issue is one that [H] executed with the county of Los Angeles on May 28, 1991, for the engineering, design, construction, and installation of a county-wide integrated radio communications system (CWIRS) for general government use. Paragraph 5A. provides that the contract is "for a fixed price of \$21,500,677.00," including, among other things, "all taxes." At the County's option, the Contractor will maintain the CWIRS for an additional \$1,067,812.00. Paragraph 4 provides for change orders. Paragraph 36 provides that the county may terminate the work for its convenience. Upon receipt of a Notice of Termination, [H] must, among other things, submit a claim and invoice to the County which will negotiate an "equitable amount to be paid Contractor by reason of the total of [or?] partial termination of work....."

OPINIONA. Fixed-Price Contracts.1. Generally.

As you are aware, on June 30, 1991, the Legislature enacted Assembly Bill 2181, Statutes 1991, Chapter 85. This bill amended Revenue and Taxation Code Sections 6051 and 6201, and added sections 6051.2, 6051.5, 6201.2, and 6201.5, which raised the state-wide sales and use tax rate to seven and one-quarter percent. (Unless otherwise cited, all subsequent statutory references are to the Revenue and Taxation Code.) This bill also added Section 6376.1 which provides that certain contracts executed prior to July 15, 1991, in which the seller is obligated to sell or the buyer is obligated to purchase tangible personal property for a fixed price are not subject to the new rates. Subsequently, the legislature enacted Senate Bill 180, Statutes 1991, Chapter 236, which amended Section 6376.1 to provide that construction contracts entered into prior to July 15, 1991, qualify for the exemption and that the exemption does not apply to contracts for any period of time in which one party to the agreement has the right to terminate the agreement upon notice, whether or not the right is exercised.

In determining whether a contract is a "fixed-price" construction contract we have consistently required that it satisfy the following criteria: (1) it be binding prior to July 15, 1991; (2) neither party has a right to terminate the contract conditioned solely upon notice; (3) the agreement must fix the amount of all costs at the outset; and (4) the agreement must include a provision which fixes the tax obligation on a tax-included basis or sets forth either the amount or the rate of tax and does not provide for an increase in the amount of tax. We regard change orders to be separate contracts. They must qualify as being for a fixed price on their own separate and apart from the main contract which they modify.

Fixed-price sales contracts are exempted from the recent rate increases under section 6376.1(a)(1)(A). The criteria for evaluating such contracts are the same as those for construction contracts except that only the buyer or the seller need be bound to perform for a fixed price, not both as in construction contracts.

2. Tax Consequences to [H].

This contract was executed prior to July 15, 1991, and the total price (exclusive of change orders) is fixed. The contract price specifically includes taxes. Therefore, elements (1), (3) & (4) of the above standard are met.

Paragraph 36 provides that the County may terminate the contract for its convenience but must reimburse [H] for work done prior to the termination. As noted above, Section 6376.1(a)(1)(C) boots construction contracts out of the fixed-price contract exemption if either party retains the right to terminate the contract solely upon notice. We have, however, consistently considered that when the obligor has the right to terminate contract for his convenience but must pay the contractor for work previously done, that is not a termination

solely upon notice. Rather, the obligor is under the continuing condition to pay the contractor for work already done. Thus, the contract cannot be terminated merely upon notice. Consequently, whether or not the items supplied are considered materials, fixtures, or machinery and equipment, the contract qualifies for the fixed-price exemption with any change orders executed after July 15, 1991, being subject to the new rates.

B. Fixtures v. Materials v. Machinery and Equipment.

1. Generally.

Regulation 1521(a) defines the above items as follows:

“(4) MATERIALS. ‘Materials’ means and includes construction materials and components, and other tangible personal property incorporated into, attached to, or affixed to, real property by contractors in the performance of a construction contract and which, when combined with other tangible personal property, loses its identity to become an integral and inseparable part of the real property....”

“(5) FIXTURES. ‘Fixtures’ means and includes items which are accessory to a building or other structure and do not lose their identity as accessories when installed...”

“(6) MACHINERY AND EQUIPMENT. ‘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, by 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. ‘Machinery and equipment’ does not include junction boxes, switches, conduit and wiring, or valves, pipes and tubing incorporated into fixed works, buildings, or other structures, whether or not such items are used solely or partially in connection with the operation of machinery and equipment, nor does it include items of tangible personal property such as power shovels, cranes, trucks, and hand or power tools used to perform the construction contract....”

* * *

“(8) LUMP SUM CONTRACT. Lump sum contract means a contract under which the contractor for a stated lump sum agrees to furnish and install materials or fixtures, or both....”

2. Tax Consequences to [H]

You asked if any of the property shown as Item 8.0 on the price summary sheet is considered fixtures or machinery and equipment. You describe the items as follows:

“The equipment is bolted to racks which in turn are bolted to the floor and walls of the integrated shelters described as ‘site development’ in the contract. The equipment may be removed from the shelter by unbolting without material damage to the shelter. The shelters are pre-fabricated and are permanently fixed to concrete pads.”

We assume that [H] is not the manufacturer of this property.

The property listed in Item 8.0 is such things as basin systems, county-wide systems, simulcast test and common equipment, site controllers, conventional repeaters, multi-site coordinators, antenna circuits, and microwave equipment. You indicate that these items do not lose their identity to become a separate and integral part of the realty but rather are bolted onto other property that is itself affixed to the realty, retain their own identity, and are readily removable without damage to the realty. They do not appear to be accessories to the buildings essential to the function of the buildings themselves but constitute property intended to be used in the delivery of the services for which the buildings were built. Indeed, such items are likely commonly removed for repair and replacement. As a result, we conclude that such items are properly considered ‘machinery and equipment’ under the above definition rather than fixtures.

[H] is the retailer of the machinery and equipment. Since the contract is for furnishing and installing the property, it is a lump-sum contract under the above definition. Thus, the gross receipts from the sale of the machinery and equipment is the price at which similar quantities ready for installation are sold at retail delivered in the market area where the property is installed. If there is no such retail price, then the gross receipts are determined from records. (Reg. 1521(b)(2)(C).) The contract, in Item 8.0, sets out the items in question along with the contract price, providing a source for determining gross receipts.

For your information, I have included a copy of Regulation 1521. I hope the above discussion has answered your question. If you need anything further, please do not hesitate to write again.

Sincerely,

John L. Waid
Tax Counsel

JLW:es