

**STATE BOARD OF EQUALIZATION**

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November 30, 1995

Mr. K--- R. M---
Attorney at Law
Post Office Box XXXX
--- ---, California XXXXX-XXXX

BURTON W. OLIVER
Executive Director

Re: C--- A--- N---

Dear Mr. M---:

Your August 28, 1995 letter to the Board's Principal Tax Auditor was referred to the Legal Division for a response. You ask whether certain activities undertaken by your client, C--- A--- N---, are exempt from tax.

You state:

"C--- A--- N--- ("CAN") is a nonprofit benefit corporation organized under the laws of the State of California CAN was formed for the purpose of demonstrating a solar-generated hydrogen refueling station, bringing clean fuel technologies to the marketplace, and making the public aware of clean fuel technologies.

"In February 1994, CAN was awarded a U.S. Government grant... to demonstrate a solar-generated hydrogen refueling station to be located at the facilities of X--- Corp. in --- ---, CA. The project is the first of its kind to use solar photovoltaics to generate energy for use in a hydrogen gas generating station. Upon completion of the project in October 1995, the demonstration project will be converted to a commercial venture, donated to the U--- of C--- --- R---'s C--- of E--- Research or dismantled.

"The facilities consist of a photovoltaic array which is used to generate 50 kWh of power and electrolyzers which are integrated with the photovoltaics to manufacture hydrogen.

The power from the photovoltaic arrays is used to electrolytically manufacture approximately 370 cubic sq. ft. of hydrogen gas per hour. The photovoltaic array was purchased from S--- Corp. of --- ---, CA in October 1994 and the electrolyzers were purchased from E--- Corp. of ---, NY in December 1994.

Under the agreement signed between the U.S. Department of Energy and CAN, title to all equipment has vested in CAN.

“The hydrogen that is manufactured is used in an on-site refueling station to serve ULEV/ZEV’s (Ultra-low emission and zero emission vehicles). X--- is the owner and operator of the refueling station. Once the hydrogen gas is manufactured, it is stored in an above-ground storage tank. The hydrogen gas is piped from the storage tank to the refueling station. A meter then measures the amount of hydrogen gas that has been dispensed. CAN charges a volumetric fee, sufficient to recover its variable costs, for the hydrogen gas that has been dispensed to owners or operators of ULEV/ZEVs.

“Pursuant to a memorandum of understanding between X--- and CAN ..., X--- delivered three of its 1993-94 ... trucks to A--- M--- D--- of ---, CA (“AMD”) to retrofit the vehicles to run on hydrogen. Pursuant to a contract between CAN and AMD, AMD provided engineering design drawings and a specially designed retrofit device that was installed in the trucks. CAN paid for the cost of the conversion from funds from the government grant Once converted, the vehicles will also have the capability to run on hythane (a mixture of hydrogen and methane) and, with some adjustment, natural gas. Under the contract between X--- and CAN, at the conclusion of the project (October 1995) X--- will transfer title to one of the vehicles to CAN.”

You ask a series of questions regarding the application tax to the above listed activities. For purposes of clarity, we have separately responded to each of your questions below.

“Issue 1.

“The photovoltaic array and the electrolyzers will be used to manufacture hydrogen. It is my understanding that under Section 6377 of the Revenue and Taxation Code that tangible personal property purchased prior to January 1, 1995 and primarily used in any stage of the manufacturing process is exempt from state sales and use taxes.

“[B]ased on the facts set forth above, [is/are:] (i) the photovoltaic array exempt from state sales and use taxes since that piece of equipment is used to manufacture hydrogen; (ii) the electrolyzers ... exempt from state sales and use taxes since those pieces of equipment are used to manufacture hydrogen; (iii) the piping and tanks use to interconnect the fueling station with the project exempt from state sales and use taxes[?]”

In order to answer your specific questions, a brief overview of the provisions of Revenue and Taxation Code section 6377¹ may be helpful in understanding our response. Section 6377 provides an exemption from a *portion* of the state component of the sales and use tax. As originally enacted, section 6377 provided an exemption from the state component of the sales and use tax, which is imposed at the rate of 6 percent. As of January 1, 1995, the exemption provided by section 6377 was reduced to tax imposed of 5 percent. Thus, if a sale meeting the requirements of the section 6377 exemption occurs on or after January 1, 1995 where the total sales tax rate is 7-3/4 percent, tax of 2-3/4 percent is due. For the remainder of this opinion, I will refer to the provisions of section 6377 as the partial sales and use tax exemption.

The partial sales and use tax exemption generally applies to persons that commence a new trade or business (discussed below) on or after January 1, 1994 inside this state which is described in codes 2000 to 3999 of the 1987 Standard Industrial Classification Manual (hereafter "SIC code"). A person meeting these requirements is a "qualified person"; however, a qualified person does not include a person who undertakes a manufacturing activity inside this state within the same SIC code division as a prior trade or business operated by that person (or any related person within the meaning of Sections 267 and 318 of the Internal Revenue Code) inside this state within the previous 36 months. The partial sales and use tax exemption generally applies to the sale or use of tangible personal property used primarily for manufacturing, processing, refining, fabricating, recycling, research and development, and the repair of qualified property.

A new trade or business is one which a person (or any related person) has not engaged in within the preceding 36 months inside this state² or which is classified in a different division of the SIC code than that person's (or any related person's) current or prior trade or business activities in this state. (Rev. & Tax. Code § 6377(b)(5)(A)(ii).) In addition, a new trade or business must commence such operations inside this state on or after January 1, 1994. (Cal. Admin. Code, tit. 18 (hereafter "Reg."), § 1525.2, subd. (c)(5)(A)³.) Generally, we regard business operations to begin upon the acquisition of operating assets that are necessary to the type of business contemplated. (See Reg. 1525.2(c)(5)(A)1.)

To claim the partial sales and use tax exemption, a person must be both pre-qualified by the Board and hold a seller's permit or maintain a consumer use tax account. (Reg. 1525.2(f).) A person qualified by the Board is issued an exemption certificate and must present that certificate to a retailer within 60 days after the purchase of qualified tangible personal property in order to claim the credit. (Reg. 1525.2(f)(1)(A)1.) A person who fails to timely claim or otherwise qualify for the partial sales and use tax exemption may nevertheless qualify for the

¹ All further references are to the Revenue and Taxation Code unless otherwise noted.

² Section 6377 makes a distinction between persons engaged in a trade or business inside this state and those that are not. Persons engaged in business wholly outside the state who commence doing business in California on or after January 1, 1994 qualify as a new trade or business regardless of that person's prior trade or business activity. (See Rev. & Tax. Code § 6377(b)(5)(A)(iii).)

³ A copy of Regulation 1525.2 is enclosed for your review.

manufacturer's investment credit (hereafter "MIC"). (See Rev. & Tax. Code §§17053.49 et seq., 23649 et seq.) The MIC is administered by the Franchise Tax Board and consists of a tax credit equal to 6 percent. Questions regarding the MIC should be addressed to the Franchise Tax Board - Legal Division, P.O. Box 1468, Sacramento, California 95812-1468.

We assume from the description in your letter that CAN is engaged in the research and development, manufacture, and sale of industrial gases described in the qualified SIC code operation of 2813.⁴ Our records indicate, however, that CAN does not maintain a seller's permit or consumer use tax account. In addition, our records do not indicate that CAN applied for (or received) a partial sales and use tax exemption certificate from the Board.⁵ Thus, the sale of the photovoltaic array, electrolyzers, piping and tanks to CAN does not qualify for the partial sales and use tax exemption. (You may nevertheless want to determine whether CAN qualifies for the MIC pursuant to sections 17053.49 et seq. or 23649 et seq.) Even if CAN had been prequalified by the Board, we note that its purchase of piping and tanks for the storage of hydrogen do not qualify for the partial sales and use tax exemption since these items are used for the storage of hydrogen and not for the process of altering raw materials into a completed form. (See Reg. 1525.2(a)(1).) If you believe that CAN qualifies for the partial sales and use tax exemption with regard to future purchases, you should contact Mr. Michael Hilbert at (916) 324-2916 for an application.

"Issue 2.

"The funds derived from the government grant were used to purchase equipment for a research and development project. If the project is deemed a success, the design will be used as a prototype for future projects. If the project is deemed not to be commercially viable, then the project will be converted to another use as described above. It is my understanding that under Section 6377 of the Revenue and Taxation Code that tangible personal property purchased prior to January 1, 1995 and primarily used in research and development is exempt from state sales and use taxes.

"[B]ased on the facts set forth above [is/are:] (i) the photovoltaic array ... exempt from state sales and use taxes since that piece of equipment is used for purposes of research and development; (ii) the electrolyzers ... exempt from state sales and use taxes since those pieces of equipment are used for purposes of research and development; (iii) the piping and tanks used to interconnect the fueling station with the project are exempt from state sales and use taxes since those pieces of equipment are used for purposes of research and development. In addition, please

⁴ SIC code 2813, Industrial Gases, is described as: "Establishments primarily engaged in manufacturing industrial gases (including organic) for sale in compressed, liquid, and solid forms...."

⁵ It is also unclear from your letter whether CAN undertook its hydrogen manufacturing operations on or after January 1, 1994.

confirm that the retrofit devices that were engineered and designed for installation in the hydrogen vehicles are exempt from state sales and use taxes since the retrofit device is used for purposes of research and development.”

Please see our response to issue one above to the extent that CAN wishes to purchase property for use in research and development activities pursuant to the partial sales and use tax exemption. There are no other sales or use tax exemption provisions relating to equipment purchased for use in research and development.

“Issue No. 3.

“Once retrofitted, the vehicles qualif[y] as Low-Emission Motor Vehicles as defined in Section 39037.05 of the Health and Safety Code. The devices satisfy all the labeling requirements of the code. As such, ... [are] the gross receipts from the sale of the retrofit devices to CAN ... exempt from sales and use taxes under Section 6356.5(b) of the Revenue and Taxation Code[?]”

We understand that CAN purchased hydrogen (and/or hythane) retrofitting devices from AMD for installation on to X---’s trucks. We further assume that AMD sold these retrofitting devices to CAN sometime prior to January 1, 1995.⁶ If so, AMD’s sale of the retrofitting devices is exempt from sales or use tax provided the retrofitting devices were identified and labeled pursuant to subdivision (b) of Section 43802 of the Health and Safety Code. If these conditions were met, AMD was not required to report and pay tax to the Board on the gross receipts from the sale of its retrofitting devices and should not have collected sales tax reimbursement from CAN on its sales of these devices.

“Issue No. 4.

“Once the hydrogen is manufactured, it is stored in an above-ground storage tank. The gas is then transported to the refueling station via an underground pipe that is approximately 25 feet in length. [Is] the sale of gas delivered by pipeline ... exempt from sales and use tax under the Revenue and Taxation Code[?]”

The exemption relevant to the sale of gas through pipelines is set forth in Revenue and Taxation Code section 6353:

“There are exempted from the taxes imposed by this part the gross receipts from the sales, furnishing, or service of and the storage, use or other consumption in this state of gas ... when delivered to consumers through mains, lines, or pipes....”

⁶ Revenue and Taxation Code section 6356.5 sunsets on January 1, 1995. (Rev. & Tax. Code § 6356.5(c).)

This means that tax does not apply to sales of gas (in gaseous form) to a customer where the gas is delivered through mains, lines or pipes. (See Business Taxes Law Guide Annot. 275.0173 (2/21/91).) Where gas is sold in liquid and not vaporized form, tax applies to the sale of the property even where the liquefied form of the gas is delivered through mains, lines or pipes. (Id.)

We assume that CAN is selling hydrogen in gaseous form and understand that it is delivered through its own pipeline to its customers. Under these facts, CAN's sale of the hydrogen is exempt from tax pursuant to section 6353.

* * * * *

We have been unable to locate a seller's permit for C--- A--- N---. Please contact my secretary, Rachel Zuniga (916) 445-6439, with CAN's seller's permit number so this letter may be appropriately filed. If you have any questions in the meantime, please write again.

Sincerely,

Warren L. Astleford
Staff Counsel

WLA:rz

Enclosure - Regs. 1525.2

cc: --- District Administrator - (--)
Supervisor, Audit Evaluation and Planning Section
Mr. Michael Hilbert