



**STATE BOARD OF EQUALIZATION**

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January 21, 1997

Mr. C--- T---  
C--- & L--- L---  
XXX --- ---, Suite XXXX  
---, California XXXXX XXXX

Re: SR -- XX-XXXXXX

Dear Mr. T---:

This is in response to your letter dated December 19, 1996 regarding the application of the partial sales and use tax exemption (hereafter "partial exemption") set forth in Revenue and Taxation Code<sup>1</sup> section 6377 to certain research and development operations undertaken by your client, I--- N---, Inc. (hereafter "I---").

You state:

"I--- obtained a California Seller's Permit effective December 1, 1995 from the State Board of Equalization ('SBE'). The company also applied for and received a Section 6377 Manufacturer's Exemption Certificate from the SBE, also effective December 1, 1995. I--- has historically used their Section 6377 Exemption Certificate on the purchase of qualified tangible personal property used in the manufacturing process.

"It has come to our attention that the company is not claiming the partial exemption provided by Section 6377 on all qualified property used in qualifying research and development ('R&D') activities. The company regularly withdraws various pieces of tangible personal property from resale inventory to be used in R&D activities. These withdrawals are currently recorded on 'Material Transfer Requests' at cost, with use tax accrued on the total cost as well. Depending on the dollar amount of the transaction, these transactions are either expensed or capitalized to R&D accounts pursuant to generally accepted accounting

<sup>1</sup> All further references are to the Revenue and Taxation Code unless otherwise noted.

principles. The scope of these activities falls within the purview of Internal Revenue Code Section 174 ‘Research and Experimental Expenditures.’”

You ask whether I--- may utilize the partial exemption with regard to its R&D activities and, if so, the general procedures for doing so.

### Discussion

The partial exemption is generally available to qualified persons that commence a new trade or business in California on or after January 1, 1994 which is described in codes 2011 to 3999 of the 1987 Standard Industrial Classification Manual (hereafter “SIC Manual”). 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 state<sup>2</sup> 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).)<sup>3</sup> The partial exemption also applies on the gross receipts from the sale to, or the storage, use, or other consumption of tangible personal property purchased by a qualified person for use by that person primarily in research and development. (Rev. & Tax. Code § 6377(a)(2); Reg. 1525.2(a)(2).) “Research and development” means those activities that are described in section 174 of the Internal Revenue Code or any regulations thereunder. (Reg. 1525.2(c)(7).)

You state that I--- is pre-qualified for the partial exemption and that it regularly withdraws tangible personal property from its resale inventory for use in R&D activities. You further state that I---’s R&D activities are within the meaning of Internal Revenue Code section 174 and that I--- self-reports tax on the cost of this property. Under these facts, I--- is entitled to take the partial exemption against the amount of tax it self-reports when it withdraws its extax inventory for use in its R&D activities. I--- must report the tax it owes on this property and claim the partial exemption on the return for the period in which it removes the property from its extax inventory and uses it in its R&D activities.

You also ask how I--- should report that portion of the tax not covered by the partial exemption and whether it should submit a completed Manufacturer’s Use Tax Declaration with each return in which it claims the partial exemption. You correctly note that I--- should report the full amount of its extax inventory withdrawal subject to use tax on line two of its sales and use tax return and then claim a corresponding deduction on line 10(e) of the same return. Pursuant to Regulation 1525.2(f)(2)(B), I--- should also attach a completed manufacturer’s use tax declaration to each of its returns in which it claims the partial exemption on property used in qualified R&D activities.

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<sup>2</sup> Section 6377 makes a distinction between persons engaged in a trade or business inside the 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).)

<sup>3</sup> “New trade or business” status is further limited in situations where a person acquires the assets of another business. (See Rev. & Tax. Code § 6377(b)(5)(A)(i).)

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

Sincerely,

Warren L. Astleford  
Tax Counsel

WLA/cmm

cc: --- --- District Administrator (--)