

**State of California
Office of Administrative Law**

**In re:
Board of Equalization**

Regulatory Action:

Title 18, California Code of Regulations

Adopt sections:

Amend sections: 1525.4

Repeal sections:

**DECISION OF DISAPPROVAL OF
REGULATORY ACTION**

Government Code Section 11349.3

OAL Matter Number: 2016-0104-01

OAL Matter Type: Regular (S)

SUMMARY OF REGULATORY ACTION

In this rulemaking action, the Board of Equalization (Board) proposed to amend section 1525.4 in title 18 of the California Code of Regulations (CCR), relating to sales and use tax exemptions for certain manufacturing and research and development equipment.

On January 4, 2016, the Board submitted the above-referenced regulatory action to the Office of Administrative Law (OAL) for review. On February 17, 2016, OAL notified the Board that OAL disapproved the proposed regulations. This Decision of Disapproval of Regulatory Action explains the reasons for OAL's action.

DECISION

OAL disapproved the above-referenced rulemaking action for the following reasons:

1. The proposed action does not comply with the authority standard of Government Code section 11349.1, subdivision (a)(2);
2. The Board did not follow required procedures of the Administrative Procedure Act (APA), Department of Finance (Finance) regulations and State Administrative Manual (SAM) including:
 - a. Failure to complete the Fiscal Impact portion of the STD Form 399 and obtain concurrence from Finance in compliance with Government Code sections 11346.5, subdivision (a)(6) and 11347.3, subdivision (b)(5); and SAM sections 6602, 6604 and 6615;
 - b. Failure to comply with the procedures for "Major Regulations" as required by Government Code sections 1346.3, subdivision (c) and 11346.36; and sections 2000, 2002 and 2003 of title 1 of the CCR; and SAM sections 6600 and 6603.

All APA issues must be resolved prior to OAL's approval of any resubmission.

DISCUSSION

Regulations adopted by the Board must generally be adopted pursuant to the rulemaking provisions of the APA contained in chapter 3.5 of part 1 of division 3 of title 2 of the Government Code. (Gov. Code, secs. 11340 through 11361.) Any regulatory action a state agency adopts through the exercise of quasi-legislative power delegated to the agency by statute is subject to the requirements of the APA unless a statute expressly exempts or excludes the regulation from compliance with the APA. (Gov. Code, sec. 11346.) No exemption or exclusion applies to the regulatory action here under review.

Before any regulation subject to the APA may become effective, the regulation is reviewed by OAL for compliance with the procedural requirements of the APA and for compliance with the standards for administrative regulations in Government Code section 11349.1. Generally, to satisfy the APA standards, a regulation must be legally valid, supported by an adequate record, and easy to understand. In this review, OAL is limited to the rulemaking record and may not substitute its judgment for that of the rulemaking agency with regard to the substantive content of the regulation. This review is an independent check on the exercise of rulemaking powers by executive branch agencies intended to improve the quality of regulations that implement, interpret, and make specific statutory law, and to ensure that the public is provided with a meaningful opportunity to comment on regulations before they become effective.

1. AUTHORITY

A. The Authority Standard; Review of Authority

To ensure promulgation of legally valid regulations, and that agencies act within the scope of their rulemaking authority, Government Code section 11349.1 tasks OAL with reviewing proposed regulations for compliance with the Authority standard of the APA. Government Code section 11349, subdivision (b), defines "Authority" as meaning, "the provision of law which permits or obligates the agency to adopt, amend, or repeal a regulation." Section 14 of title 1 of the CCR provides in pertinent part:

- (a) Sources of "Authority." "Authority" shall be presumed to exist only if an agency cites in its "authority" note proposed for printing in the California Code of Regulations:
 - (1) a California constitutional or statutory provision which expressly permits or obligates the agency to adopt, amend, or repeal the regulation; or
 - (2) a California constitutional or statutory provision that grants a power to the agency which impliedly permits or obligates the agency to adopt, amend, or repeal the regulation in order to achieve the purpose for which the power was granted.
- (b) [...]
- (c) Review of "Notes." In reviewing "notes," OAL shall use the same analytical approach employed by the California Supreme Court and the California Court of Appeal, as evidenced in published opinions of those courts.

(1) For purposes of this analysis, an agency's interpretation of its regulatory power, as indicated by the proposed citations to "authority" or "reference" or any supporting documents contained in the rulemaking record, shall be conclusive unless:

- (A) *the agency's interpretation alters, amends, or enlarges the scope of power conferred upon it; or*
- (B) *a public comment challenges the agency's 'authority'....[Emphasis added.]*

As discussed below, OAL finds that the Board's proposed action alters, amends and/or enlarges the scope of power conferred upon the Board. Additionally, a public comment was submitted by Finance challenging the Board's rulemaking authority.¹ Therefore, the Board's interpretation of its authority is not conclusive.

B. The Board's Proposed Amendment of Section 1525.4, Title 18 of the CCR

Revenue and Taxation Code section 6377.1, subdivision (b), sets forth requirements for certain types of "qualified tangible personal property" which are eligible for the sales and use tax exemption provided by Revenue and Taxation Code section 6377.1. Section 6377.1 requires that certain tangible property have a "useful life" of one or more years in order to qualify for the exemption. Section 6377.1, subdivision (b)(10) defines "useful life" as follows:

(10) "Useful life" for tangible personal property **that is treated as having a useful life of one or more years for state income or franchise tax purposes shall be deemed** to have a useful life of one or more years for purposes of this section. "Useful life" for tangible personal property **that is treated as having a useful life of less than one year for state income or franchise tax purposes shall be deemed** to have a useful life of less than one year for purposes of this section. [Bolding added.]

In this action, to further implement Revenue and Taxation Code section 6377.1, the Board proposes to amend section 1525.4, subdivision (b)(13), contained in title 18 of the CCR. The proposed amendments to section 1525.4, reflected in underline, are as follows:

(13)(A) "Useful life." Tangible personal property that the qualified person treats as having a useful life of one or more years for state income tax or franchise tax purposes shall be deemed to have a useful life of one or more years for purposes of this regulation. Tangible personal property that the qualified person treats as having a useful life of less than one year for state income or franchise tax purposes shall be deemed to have a useful life of less than one year for purposes of this regulation.

¹ / Finance's comment challenging the Board's authority stated "As Finance has noted previously, the Board of Equalization lacks the statutory authority to enact the proposed amendments to the sales tax exemption regulations. The statute is very clear in outlining the requirements for manufacturers to qualify for the exemption, and as the board acknowledged in the August meeting, these amendments would overstep the delegated authority."

(B) For purposes of applying subdivision (b)(13)(A), tangible personal property that meets any one of the following criteria shall be deemed as having a useful life of one or more years for state income or franchise tax purposes:

1. Tangible personal property included under a warranty by the manufacturer or other third party to last one or more years shall be treated as having a useful life of one or more years for purposes of this regulation.

2. Tangible personal property that is included under a maintenance contract lasting one or more years shall be treated as having a useful life of one or more years for purposes of this regulation.

3. Tangible personal property that is normally replaced at intervals of one or more years, as established by industry or business practices or based on the actual experience of the person claiming the exemption, or is expected at the time of purchase to last one or more years, as established by industry or business practices or based on the actual experience of the person claiming the exemption, shall be treated as having a useful life of one or more years for purposes of this regulation.

(C) Examples: Useful life is determined by answering the following questions for tangible personal property:

Example 1. Is the tangible personal property capitalized for state tax purposes or accounting purposes?

- If the answer is "yes," it meets the useful life requirement.
- If the answer is "no," go to the next question.

Example 2. Is the tangible personal property warranted by the manufacturer or other third party to last one year or more?

- If the answer is "yes," it meets the useful life requirement.
- If the answer is "no," go to the next question.

Example 3. Is the tangible personal property normally replaced at intervals of one year or more, as established by industry or business practice? (This is commonly based on the actual experience of the person claiming the exemption.)

- If the answer is "yes," it meets the useful life requirement.
- If the answer is "no," go to the next question.

Example 4. Is the tangible personal property expected at the time of purchase to last one year or more, as established by industry or business practice? (This is commonly based on the actual experience of the person claiming the exemption.)

- If the answer is "yes," it meets the useful life requirement.
- If the answer is "no," it does not meet the useful life requirement.

C. The Proposed Amendments to Section 1525.4 Are Outside the Scope of Rulemaking Authority Granted to the Board.

In proposing to amend section 1525.4, the Board relies on Revenue and Taxation Code section 7051 for its rulemaking authority. Section 7051 provides that “[t]he board shall enforce the provision of this part and may prescribe, adopt, and enforce rules and regulations relating to the administration and enforcement of this part.”² This section vests broad authority with the Board to adopt regulations to administer and enforce statutes and regulations relating to sales and use taxes in California, which includes authority to implement Revenue and Taxation Code section 6377.1.

Revenue and Taxation Code section 6377.1, subdivision (b)(1) specifies that deemed useful lives of certain tangible personal property are to be determined by how the property is treated for state income and franchise tax purposes. This shows the Legislature intended to look to state income and franchise tax law to govern when making this determination. The Board is charged with the collection of sales and use taxes throughout the State of California; however the Franchise Tax Board administers and enforces state income and franchise taxes. (Rev. & Tax Code, sec. 19503.) Thus, the Franchise Tax Board has the rulemaking authority to adopt regulations dealing with state income and franchise tax law.

The Board first adopted regulation section 1525.4 in 2014. At that time, section 1525.4, subdivision (b)(13) simply stated: “Tangible personal property that the qualified person treats as having a useful life of one or more years for state income or franchise tax purposes shall be deemed to have a useful life of one or more years for purposes of this regulation.” In the current action, however, the Board proposes to amend section 1525.4 to specify certain situations relating to personal property that will deem the property as having a useful life of one or more years for state income or franchise tax purposes. As noted above, section 7051 vests the Board with the authority to adopt regulations to administer and enforce sales and use taxes; however, the Franchise Tax Board has the authority to adopt regulations that deal with state income and franchise tax laws. Thus, the Board’s attempt to amend section 1525.4 to specify how tangible property is treated for state income or franchise tax purposes is outside the rulemaking authority granted to the Board by Revenue and Taxation Code section 7051.

D. The Proposed Amendment of Section 1525.4 Alters and/or Amends the Scope of Revenue and Taxation Code Section 6377.1.

Government Code section 11342.1 states, in part, “Each regulation adopted, to be effective, *shall be within the scope of authority conferred* and in accordance with standards prescribed by other provisions of law.” (Emphasis added.) Government Code section 11342.2 provides that “[w]hensoever by the express or implied terms of any statute a state agency has authority to adopt

² / The language “this part” as used in section 7051 refers to Part 1, titled “Sales and Use Taxes” of Division 2 of the Revenue and Taxation Code. The Board is also charged with enforcing other taxes in California, such as property taxation (Gov. Code, sec. 15606.) and other special taxes, such as excise taxes on tobacco and alcohol. (Rev. & Tax Code, secs. 30451 and 32451.)

regulations to implement, interpret, make specific or otherwise carry out the provision of the statute, no regulation adopted is valid or effective unless consistent and not in conflict with the statute and reasonably necessary to effectuate the purpose of the statute.” “Administrative regulations that alter or amend the statute or enlarge or impair its scope are void.” (*Pulaski v. California Occupational Safety & Health Standards Bd.* (1999) 75 Cal.App.4th 1315, 1332 [hereinafter “*Pulaski*”].)

In *Pulaski*, the Court reviewed regulations adopted by the Department of Industrial Relations’ Occupational Safety and Health Standards Board (Standards Board) to address repetitive motion injuries in the workplace. (*Pulaski, supra*, 75 Cal.App.4th at pp. 1325-1326.) The Standards Board’s regulations implemented Labor Code section 6357, which stated in part that “the [Standards Board] shall adopt standards for ergonomics in the workplace designed to minimize the instances of injury from repetitive motion.” (*Id.* at 1325.) The Standards Board also had broad rulemaking authority pursuant to Labor Code section 6307, granting the Standards Board “the power, jurisdiction, and supervision over every employment and place of employment in this state, which is necessary to adequately enforce and administer all laws and lawful standards...requiring such employment and place of employment to be safe...” (*Id.* at 1339.)

In adopting regulations containing ergonomic standards, the Standards Board included a small business exemption, which was challenged by labor groups. In striking down the small business exemption, the Court found that because the Standards Board is required to ensure that all workplaces and places of employment were safe (Lab. Code, sec. 6307.), the small business exemption for ergonomic standards (Lab. Code, sec. 6357.) was inconsistent with the statute and therefore beyond the Standards Board’s authority. (*Pulaski, supra*, 75 Cal.App.4th at pp. 1340-1341.) As the Court noted, “Because the exemption is inconsistent with the mandate of section 6357, it was jurisdictionally infirm. There is no agency discretion to promulgate a regulation which is inconsistent with the governing statute. [citation omitted.] Accordingly, we need not concern ourselves with whether the exemption is wise or reasonable as a matter of policy. If it transgresses the statutory power of the agency, it is invalid.” (*Pulaski*, at 1341 [Internal citations and quotes omitted].)

In this action, the Board has similarly attempted to adopt language that is inconsistent with the mandate set forth in the statute and therefore the Board has acted beyond its rulemaking authority. Revenue and Taxation Code section 6377.1, subdivision (b)(10), includes mandatory language for the treatment of tangible personal property requiring that the property shall be deemed to have a useful life for purposes of section 6377.1 that is the same as how the property was treated for state income or franchise tax purposes. Contrary to the language in section 6377.1, the proposed amendments would “deem” certain tangible personal property to have a useful life of one or more years if it meets any of the Board’s criteria regardless of how the property is actually treated for state income and franchise tax purposes.

While Revenue and Taxation Code section 7051 vests the Board with broad rulemaking authority relating to sales and use taxes, the language in Section 6377.1, subdivision (b)(10), specifies deemed useful lives of property based on how the property is treated for state income and franchise tax purposes. This provision shows the Legislature’s intent to look to state income and franchise tax law when making this determination. Thus, similar to the court in *Pulaski*,

because proposed amendments to section 1525.4 alter and amend the scope of Revenue and Taxation Code section 6377.1, subdivision (b)(10), the amendments transgress the statutory power of the Board. (Gov. Code, secs. 11342.1 and 11342.2; *Pulaski, supra*, 75 Cal.App.4th at p. at 1341.)

For these reasons, OAL finds that the Board's proposed amendments to section 1525.4 does not comply with the authority standard.

2. INCORRECT PROCEDURE

A. Fiscal Impact Statement and Department of Finance Concurrence

Government Code section 11346.5, subdivision (a)(6), requires that the notice of proposed adoption, amendment, or repeal of a regulation include "An estimate, prepared in accordance with the instructions adopted by the Department of Finance, of the cost or savings to any state agency, the cost to any local agency or school district that is required to be reimbursed under Part 7 (commencing with Section 17500) of Division 4, other nondiscretionary cost or saving imposed on local agencies, and the cost or savings in federal funding to the state."

Government Code section 11357 requires the Department of Finance (Finance) to adopt instructions for inclusion in the SAM for determining and making estimates for fiscal or economic impacts required by Government Code sections 11346.2, 11346.3 and 11346.5. Government Code section 11357, subdivision (c), provides "[t]he Department of Finance may review an estimate prepared pursuant to this section for content, including but not limited to, the data and assumptions used in its preparation." Instructions adopted by Finance for making fiscal and economic estimates by state agencies are included in the SAM. (SAM, secs. 6600-6615.)

In defining "revenues", SAM section 6602 provides that "[a]ny changes in the amounts of operating income received by state and local agencies as a result of an executive regulation must be identified. **In this context, 'revenue' includes taxes**, state and/or federal assistance, fees, licenses, and so forth." (Bolding added.)

SAM section 6604 states:

A state agency that adopts, amends, or repeals a routine regulation or emergency regulation must make a local mandate determination and an estimate of fiscal impact resulting from the 'regulation' on the following:

State Agencies

...

3. Any other impacts such as revenue changes.

SAM section 6615 provides: "A state agency is not required in all instances to obtain the concurrence of the [Finance] in its estimate of the fiscal impact of its proposed regulation on governmental agencies. **Such concurrence is required when the adoption, amendment, or repeal of a regulation results in local agency costs or savings, in state agency costs or savings,**

or in other non-discretionary instances such as local/state revenue increases or decreases which must be depicted on the STD as follows: A.1 Reimbursable Local Costs, A.2 – Non-Reimbursable Local Costs, A.3 – Local Savings, A.6 – Other, B.1 – State Costs, B.2. – State Savings, B.4 – Other.” (Bolding added.)

Regulation section 1525.4 was first adopted by the Board in 2014 to implement Revenue and Taxation Code section 6377.1. At the time section 6377.1 was enacted, Finance estimated that the amount of annual purchases/sales in the 2014-2015 fiscal year that could benefit from this exemption was \$15 billion. If fully utilized, this exemption would result in approximately \$486 million in sales and use tax savings for qualified persons as defined the statute. (Sen. Rules Com., Off. of Sen. Floor Analyses, 3d reading analysis of Assem. Bill No. 93 (2013-2014 Reg. Sess.) as amended June 24, 2013.)

In this action, the Board proposes to amend section 1525.4, subdivision (b)(13). The proposed amendments add criteria for determining the “useful life” of tangible personal property for purposes of determining whether the sales and use tax exemption applies. The justification for the proposed amendments is that there is confusion on the part of taxpayers as to what purchases qualify for the exemption and therefore the exemption is being underutilized. (Initial Statement of Reasons (ISR), pp. 5-6 & 7-8.) The ISR states “that ‘for the first year, the [] exemption usage was anticipated to be [based on] approximately \$15 billion [of expenditures]. However, based upon returns to date, we have [only] seen approximately \$3 billion of usage’ which may be due to the perceived ambiguities in the statute.” (ISR, p. 8.) The ISR further states that the proposed amendments are intended “to ensure that the [] exemption provided by Revenue and Taxation Code section 6377.1 is utilized as originally intended by the Legislature”. (ISR, p. 8.)

For the Fiscal Impact Statement portion of the STD Form 399, regarding fiscal impact on state agencies, the Board checked box B.3., indicating “no fiscal impact exists. This regulation does not affect any State agency or program.” (STD Form 399, p.5.)

During the 45-day public comment period, Finance submitted a comment to the Board. With regard to the fiscal impact of the Board’s proposed amendments to section 1525.4, Finance’s comment states:

The argument that these amendments would have no revenue impact because they ‘would be consistent with the implementing statute’ is insufficient. Even when legislation contemplates increased expenditures or revenue losses (tax expenditures), they must be reflected in the STD 399. In addition, to the extent these regulations are further revised to resolve a statutory ambiguity to increase utilization of the exemption, the increase in the exemption over what would be expected under the current regulations would result in a revenue loss. Therefore, this revenue loss results in a fiscal impact. As the amendments would trigger a fiscal impact from the additional exemptions, a signature is also required from Finance on the STD 399 before these regulations can be adopted. If OAL chooses to allow the board to proceed with these regulations, that STD 399 must be forwarded to Finance for approval.

(Nov. 10, 2015 Letter from Kristin Shelton, Program Budget Manager,
Department of Finance.)

In response to Finance's comment, the Board maintained the position that the proposed amendments do not have any fiscal impact because the amount of any revenue loss does not come from the proposed amendment, but from Revenue and Taxation Code section 6377.1 and from the intent of the Legislature that this exemption be fully utilized in the amounts originally estimated by Finance. (FSR, pp. 3-5.)

Pursuant to SAM section 6615, if the Board's proposed amendments increase or decrease local/state revenue, then the Board must check box "B.4 – Other" in the Fiscal Impact portion of the STD Form 399 and must also obtain Finance concurrence. As noted above, underutilization of the exemption has resulted in approximately \$3 billion in sales and use tax exemptions out of the intended \$15 billion. The Board's stated purpose of the current proposed amendments is to increase utilization of this exemption, which, if successful could result in as much as a \$364.5 million decrease in revenue from sales and use taxes to the state. Therefore, the Board was required to check box "B.4 – Other" in the Fiscal Impact Statement of the Form 399 to reflect this decrease in revenue to the state and to obtain Finance concurrence. (SAM, sec. 6615.)

In light of the foregoing, the Board failed to follow procedures to properly complete the STD Form 399 and obtain the required signature from Finance on the STD Form 399 as mandated by the Government Code and SAM.

B. Major Regulations

Government Code section 11346.3, subdivision (c) requires "[e]ach state agency proposing to adopt, amend, or repeal a major regulation on or after November 1, 2013, shall prepare a standardized regulatory impact analysis in the manner prescribed by the Department of Finance pursuant to Section 11346.36." Subdivision (c) goes on to specify economic impacts that the standard regulatory impact analysis (SRIA) "shall address".

Government Code section 11346.3, subdivision (f) requires "[e]ach state agency ... that has prepared a standardized regulatory impact analysis pursuant to subdivision (c), shall submit that analysis to the Department of Finance upon completion." Subdivision (f) goes on to require Finance to provide comments to the rulemaking agency on the agency's analysis and requires the agency to respond to Finance's comments.

Government Code section 11346.36 requires Finance to adopt regulations for conducting the SRIA as required by Government Code section 11346.3, subdivision (c). Section 11346.36, subdivision (e), provides that the SRIA "shall be included in the initial statement of reasons for the regulation as provided in subdivision (b) of Section 11346.2."

Government Code section 11357, subdivision (c), provides "The Department of Finance may review an estimate prepared pursuant to this section for content, including but not limited to, the data and assumptions used in its preparation."

Title 1, CCR section 2000, defines a “major regulation” as “any proposed rulemaking action adopting, amending or repealing a regulation subject to review by OAL that will have an economic impact on California business enterprises and individuals in an amount exceeding fifty million dollars (\$50,000,000) in any 12-month period between the date the major regulation is estimated to be fully implemented (as estimated by the agency), computed without regard to any offsetting benefits or costs that might result directly or indirectly from that adoption, amendment or repeal.”³

Section 2000 defines “economic impact” for purposes of determining whether a regulation is a “major regulation” as “all costs or benefits (direct, indirect and induced) of the proposed major regulation on business enterprises and individuals located in or doing business in California.”

The stated purpose of the proposed amendments is to increase the current utilization of approximately \$3 billion to closer to the \$15 billion as originally estimated when Revenue and Taxation Code section 6377.1 was enacted by the Legislature. (ISR, pp. 5-6 & 7-8.) If successful, the proposed amendments would result in a revenue loss to the state of approximately a \$364.5 million. This revenue loss to the state would be a \$364.5 million economic benefit to businesses and other entities otherwise subject to the tax. This amount exceeds the \$50 million threshold invoking the major regulation requirements set forth above.

Finance’s comment to the Board states:

...[T]he proposed regulations meet the \$50 million economic impact threshold for major regulations. As a result, a SRIA is required before the regulations can be adopted or the rulemaking process finalized pursuant to the California Code of Regulations. The sales tax exemption amendments have the stated purpose of encouraging manufacturers to purchase additional equipment without paying sales tax. While the level of additional exemptions claimed under the proposed amendments is not clear, the board notes that in the current year the amount of qualified expenditures claims was \$12 billion less than was anticipated when the legislation was adopted. If even a small fraction of this \$12 billion gap is closed by these amendments, the threshold of \$50 million of economic activity in one twelve-month period would be exceeded. (Nov. 10, 2015 Letter from Kristin Shelton, Program Budget Manager, Department of Finance.)

In the Final Statement of Reasons (FSR), the Board responds to Finance’s comment, stating that the proposed regulations have no economic impact because “they are intended to ensure that the partial exemption is utilized at the level the Legislature intended, and will not result in a loss of revenue in excess of the amount the Governor and the Legislature have allocated.” (FSR, p. 4.) The Board further responds that the “proposed amendments are merely a clarification ‘that does not increase costs.’” (FSR, p. 5.)

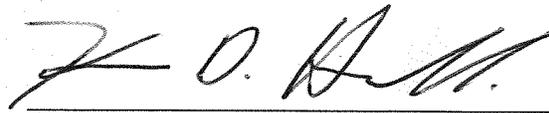
³ / “Major Regulation” is also defined in Government Code section 11342.548.

Given that the proposed regulations would result in an economic benefit of more than \$50 million, and based on the findings by Finance, the requirements for the adoption of a major regulation must be complied with in accordance with the APA and Finance regulations and instructions. The Board has failed to comply with these requirements, therefore, OAL cannot approve this proposed rulemaking.

CONCLUSION

For the reasons set forth above, OAL has disapproved this regulatory action. If you have any questions, please contact me at (916) 323-8916.

Date: February 24, 2016



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