# STATE BOARD OF EQUALIZATION

LEGAL DIVISION (MIC:82)
450 N STREET, SACRAMENTO, CALIFORNIA
(PO BOX 942879, SACRAMENTO, CALIFORNIA 94279-0082)
TELEPHONE (916) 327-2291
FAX (916) 323-3387



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January 26, 1998

Mr. P--- de B---
P--- General Contractors &
Cabinetmakers, Inc.
XX-- --- Avenue
--- --- California XXXXX

**Re: Meaning of Term "Direct Cost" for Purposes of Regulation 1521**
**SR -- XX-XXXXXX**

Dear Mr. de B---:

This is in response to your letter of December 15, 1997, transmitted by facsimile, in which you inquire about the application of Regulation 1521(c)(1).

Regulation 1521 specifically concerns construction contractors and the application of tax to construction contracts. Subdivision (a)(1)(A)1 of Regulation 1521 defines a construction contract to include a contract to erect, construct, alter, or repair any building or other structure. On the basis of your inquiries we assume that your company P--- General Contractors & Cabinetmakers, Inc. (P---) is a construction contractor.

Regulation 1521 defines the terms "materials" and "fixtures" as those terms apply to construction contractors. "Materials" are construction materials and components, and other tangible personal property incorporated into, attached or affixed to real property such as a building by a 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).) A construction contractor is the consumer of materials which the contractor furnishes and installs in the performance of a construction contract. Tax applies to the sale to, or use by, the contractor of those materials. (Reg. 1521(b)(2)(A)1.)

"Fixtures" are items which are accessory to a building or other structure and do not lose their identity as accessories when installed. (Reg. 1521(a)(5).) A construction contractor is generally the retailer of fixtures which the contractor furnishes and installs in the performance of a construction contract, and tax applies to the sale of the fixture by the construction contractor to a customer. (Reg. 1521(b)(2)(B).)

For sales and use tax purposes, when cabinets are furnished and installed pursuant to a contract, they are sometimes considered materials and sometimes considered fixtures. As indicated above, the status of the cabinets as either materials or fixtures determines the application of the tax. Regulation 1521(c)(2) states the rule for determining whether a cabinet is materials or a fixture for sales and use tax purposes. A cabinet is considered to be "prefabricated" and, therefore, a fixture when 90 percent of the total direct cost of labor and materials used for fabricating and installing the cabinet is incurred before the cabinet is affixed to the real property (building). In determining this 90 percent, the total direct cost of all labor and materials used in fabricating the cabinet to the point of installation is compared to the total direct cost of all labor and materials used in completely fabricating and installing the cabinet. (Reg. 1521(c)(2).)

Your first inquiry is whether the term “direct cost” includes labor burdens such as “worker’s compensation, medical coverage and income taxes.”

Regulation 1521(b)(2)(B), which explains the factors to be considered in computing “sales price” of a fixture when the contractor is the manufacturer of the product, includes, as the second category, “direct labor, including fringe benefits and payroll taxes.” Accordingly, in calculating whether a cabinet is considered to be “prefabricated” pursuant to Regulation 1521(b)(2)(B), “labor burdens such as workers compensation, medical coverage and income[/payroll] taxes” **are included** in computing the direct cost of labor used in fabricating and installing the cabinets.

Your next inquiry is the classification and sales and use tax consequences attributable to cabinets which do not qualify as “prefabricated” under the calculations prescribed by Regulation 1521(c)(2).

If less than 90 percent of P---’s total direct cost for labor and materials to make and install a cabinet is incurred prior to the time P--- attaches the cabinet to the building, the cabinet is considered materials. As explained above, P--- is considered to be the consumer of materials which it is furnishing and installing, and tax is due only on the sale of the materials to P---, or if not paid at that time, on P---’s use of the materials.

Your last inquiry is based on a situation whereby a person uses P---’s “shop area” to “work on his/her project for an hourly rate.” You ask “is that hourly rate charged by [P---] subject to sales tax?”

We assume that the hourly rate charged is for the use of P---’s tools and equipment, tangible personal property. In California the general rule is that a lease of tangible personal property is a continuing sale and purchase. For most leases that are continuing sales, the applicable tax is the use tax which is measured by the rentals payable and which must be collected by the lessor from the lessee at the time the rentals are paid and must be remitted to the Board. (Rev. & Tax. Code §§ 6006(g), 6006.1, 6010(e), 6010.1; Reg. 1660(c)(1).) A lease of tax-paid property will not be considered a taxable continuing sale subject to use tax. A lessor

leasing tangible personal property in substantially the same form as acquired may elect to pay California sales or use tax measured by the purchase price. The lessor may make this election by either paying sales tax or use tax to its vendor when purchasing the property or by paying use tax, measured by the purchase price, directly to the Board with its timely return for the reporting period in which the property is first placed into rental service. (Reg. 1660(c)(2).)

In this case, since the equipment was purchased for P---'s use, we assume that either sales or use tax was paid on the equipment and tools at the time of purchase. Under these circumstances, sales tax would not apply to the hourly rate charged for use of the tools and equipment on P---'s premises. If ,for some reason, neither sales nor use tax had been paid on the tools and equipment subject to the hourly rate, sales tax would not apply to the rental receipts if the use of the tools and equipment are considered to be a grant of privilege which is not considered to be a lease. Regulation 1660(e)(1) explains:

> "Certain restricted grants of a privilege to use property are excluded from the term 'lease.' To fall within the exclusion, the use must be for a period of less than one continuous 24-hour period, the charge must be less than $20, and the use of the property must be restricted to use on the premises or at a business location of the grantor of the privilege to use the property."

Thus, if neither sales nor use tax had been paid on the tools and equipment subject to the hourly rate **and** the privilege to use the tools and equipment is for a period of less than a 24 hours; the use takes place on P---'s premises; and the charge is less than $20, sales tax will not apply to the hourly rate charged. Conversely, if sales or use tax was not paid upon the acquisition of the property and if the privilege to use the property is for more than a 24 hour period, or the property is used at a place other than the premises of P---, or the total charge for use of the property is more than $20, sales tax will apply to P---'s "hourly rate." We have included a copy of Regulation 1660 for your review.

If you have any further questions, please feel free to contact this office again.

Sincerely,

Patricia Hart Jorgensen
Senior Tax Counsel

PHJ:cl

Enclosure (Regulation 1660)
cc: Oakland District Administrator