State of California

Board of Equalization
Legal Division

Memorandum

325.0013.200

To : Gary Jugum
Assistant Chief Counsel

Date : August 10, 1992

From : Elizabeth Abreu
Tax Counsel

Subject : First Functional Use Test

By memorandum dated April 30, 1992, you transmitted Don Hennessy's April 27, 1992 memorandum requesting our position on the first functional use test as it applies to vehicles, vessels, and aircraft. The issue was raised during a Board hearing in which Mr. Nunes discussed the possibility that, at least as to an item such as a cargo truck, the Department would not find a functional use until there was cargo on the truck, i.e., that the driving of a truck into California empty would not be a functional use outside of California.

A. Functional Use Test – Statutory and Judicial Authorities

Revenue and Taxation Code section 6201 imposes the use tax on the storage, use, or other consumption in this state of tangible personal property purchased from any retailer for storage, use, or other consumption in this state. The use tax complements the sales tax with the purpose of placing local retailers and their out-of-state competitors on an equal footing. The use tax prevents an unfair burden from being place upon the local retailer engaged solely in intrastate commerce as compared with the case where the property is purchased for use or storage in California and is used or stored in this state. Since property covered by the sales tax is exempt from use tax, all tangible personalty sold or utilized in California is taxed only once for the support of the state government. Chicago Bridge & Iron Co. v. Johnson (1941) 19 Cal. 2d 162, 165-166.

A purchase is not subject to use tax unless the following conditions are met: (1) the tangible personal property stored or used must be purchased by the storer or user; (2) the purchase must have been made from a retailer; (3) the property must have been purchased for use or storage in this state; and (4) the property must have been purchased or stored in this state. Chicago Bridge & Iron Co. v. Johnson (1941) 19 Cal.2d 162, 167.

In American Airlines Inc. v. State Board of Equalization (1963) 216 Cal.App.2d 180, the court, in reaching its conclusion that use tax applied to the purchase of the property in issue, refers to the "basic or functional use" of such property. In this case American Airlines had purchased new engines and propellers outside of California and had taken delivery in Tulsa, Oklahoma. After storage in Tulsa lasting from 21 days to 292 days and averaging 132 days, the engines and propellers were shipped by truck or air to American's Los Angeles facilities where

they were installed onto aircraft. After installation, the engines and propellers were used about 94 percent of the time outside of California.

At the time the court decided American Airlines the Board had not issued Regulation 1620(b)(3). The court's opinion and this part of the regulation, however, are consistent if the court regarded the first functional use of the engines and propellers to be inside of California. Under the regulation, the engines and properllers which were stored in Tulsa over 90 days could only have been taxable under the 90-day, 6-month rule if their first functional use was inside of California.

With respect to functional use, the court states:

> "The storage was preliminary to the ultimate functional use of the items and under the statutory definitions and the interpretations put thereon all of the items were purchased for storage and use in California." (216 C.A. 2d at 191)
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> …
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> "There can be no doubt that American purchased the items with which we are concerned for a purpose which contemplated that American would exercise right and power over the items as an incident of ownership, namely among other things that the items would be stored and installed in this state. The functional purpose of the items was to make the aircraft operational and the property was purchased and brought into this state for such purpose and committed in California to such purpose." (216 C.A.2d at 192)
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> …
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> "Furthermore, it appears that respondent repeatedly has ruled that if tangible personal property was committed to its functional or basic use in this state by way of installation or otherwise, it was subject to the use tax, even though the taxpayers may have exercised some power out of state after its purchase out of state, including testing or integrating into other personal property." (216 C.A.2d at 193)

In The Atchison, Topeka and Santa Fe Railway Company v. State Board of Equalization (1955) 131 Cal.App.2d 677 the court appears to be holding that storing parts which are maintained for repairs and installing them permanently to equipment is a functional use of such property.

In Parfums-Carday, Inc. v. State Board of Equalization (1986) 186 Cal.App.3d 630 Max Factor sold "promotional prepacks" which consisted of a counter or promotional display and an assortment of cosmetic merchandise. Max Factor purchased the displays under a resale

certificate, stored the displays in a warehouse, assembled them into prepacks, and then shipped them to its customers. The court, in holding that section 6099.1 did not apply, held that if property has some "functional purpose" in California other than to serve as a mere object in transit, there is a taxable use.

B. Functional Use Test – Purpose and Application

Regulation 1620(b)(3) specifically defines functional use, the term under consideration in this memorandum. This definition is "use for the purposes for which the property was designed." The definition of "use" in Revenue and Taxation Code section 6009 includes "the exercise of any right or power over tangible personal property incident to the ownership of that property..."

It is evident from the cases discussed above and these definitions that functional use has a narrower meaning than use. Functional or basic use is something more than exercising mere ownership rights or transporting, testing, or storing the property. However, storing property within a state for maintenance and repairs and subsequently installing the property in that state is a functional use.

The functional use test is used in several regulations to determine if out-of-state purchases of property are subject to use tax. On November 18, 1978, the Board expressly incorporated the functional use test into the regulations by adding subsection (b)(2) and (3) to Regulation 1620.

Regulation 1620(b)(2)(B)

> "Use tax does not apply to property purchased for use and used in interstate or foreign commerce prior to its entry into this state, and thereafter used continuously in interstate or foreign commerce both within and without California and not exclusively in California."

Although this regulation only implies, rather than specifically states, that the interstate commerce exemption cannot apply where property is first functionally used in California, the Board's staff has concluded that if a vehicle is first used in California without any prior functional use outside of the state, it is presumed that it was purchased for use in California and use tax appliess even though used in interstate commerce. Annotation 570.0430.

Regulation 1620(b)(3) reads:

> "Property purchased outside of California which is brought into California is regarded as having been purchased for use in this state if the first functional use of the property is in California. When the property is first functionally used outside of California, the property will nevertheless be presumed to have been purchased for use in this state if it is brought into California within 90 days after its purchase, unless the property is used or stored outside of California one-half or more of the time during the six month period immediately following its entry into this state. Prior out-of-state use not exceeding 90 days from the date of purchase to the date of entry into California is of a temporary nature and is not proof of an intent that the property was purchased for use elsewhere. Prior out-of-state use in excess of 90 days from the date of purchase to the date of entry into California, exclusive of any time of shipment to California, or time of storage for shipment to California, will be accepted as proof of an intent that the property was not purchased for use in California."

Thus, under this part of the regulation, if property is first functionally used inside of California, it is taxable even though purchased more than 90 days prior to entry into this state.

Revenue and Taxation Code section 6248 provides that there shall be a rebuttable presumption that any vehicle subject to registration which is bought outside of California and brought into California within 90 days from the date of its purchase is acquired for storage, use or other consumption in this state. Regulation 1610(e)(2) reads, in part:

> "... Prior out-of-state use in excess of 90 days from the date of purchase to the date of entry into California, exclusive of any time of shipment to California, or time of storage for shipment to California, will be accepted as proof of an intent that the vehicle was not purchased for use in California. Accordingly, when a vehicle is purchased in a foreign country or in another state and is later shipped to California, the period of use for purposes of the 90-day test will be measured by the interval from the time the purchaser takes possession at the out-of-state point to the time when the vehicle is delivered to a shipping agent or placed in storage for shipment to California."

Although this regulation does not specifically refer to the functional use test, it implies that a vehicle must be first functionally used elsewhere since the 90-day test period excludes time of storage.

Annotation 570.0430 (1/7/74, 3/23/84), relating to vehicles purchased for use in interstate commerce, gives the following example of the functional use of vehicles:

> "...[I]f the only use of a truck outside of California were to drive it empty to California to pick up any payload it could find, the first functional use would in California. However, if it were dispatched to California to pick up a specific payload, the first functional use would be outside of California."

Annotation 570.0510 (4/7/78) gives a similar example, as follows:

> "If a lessor of a vessel were to transport the vessel by its own power into California in order to lease it to any lessee he could find, the first functional use would be in California. However, if the vessel were transported by its own power into California in order to fulfill delivery to a specific lessee, the first functional use would be outside California."

Based on the foregoing, I conclude that if a vehicle or vessel is designed for commercial carriage, e.g., a bus, a tractor-trailer, or a sightseeing boat, the first functional use will be outside of California if passengers are boarded or cargo is loaded onto the vehicle or vessel outside of California. If such a vehicle or vessel is deadheaded into California, the first functional use will be in California unless the vehicle or vessel is brought to California to fulfill an existing lease or charter or to pick up a specific load of cargo or group of passengers. The same applies to aircraft though in most instances the purchases of such aircraft will be exempt under Revenue and Taxation Code section 6366 or 6366.1.

With respect to vehicles, vessels, and aircraft designed for personal use, such as a passenger vehicle as defined in Vehicle Code section 465, a small motor boat, or a small plane, the first trip or flight into California is a functional use outside of California without regard to who drives or pilots the vehicle, vessel, or aiarcraft or to whether it is carrying passengers or cargo.

Vehicles, vessels, and aircraft which are designed for commercial purposes are not functionally used until used for the commercial purpose for which they were designed. For example, a commercial fishing boat is not functionally used until it is used on waters for fishing.

Finally, regardless of what purpose the vehicle, vessel, or aircraft was designed for, the first functional use of such items will be in California if they are not brought into California under their own power and they have not otherwise been functionally used outside of California.

Elizabeth Abreu