

STATE OF CALIFORNIA

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OFFICE OF ADMINISTRATIVE LAW

Bill Jones
SECRETARY OF THE STATE

In re:)	
Request for Regulatory)	1999 OAL Determination No. 26
Determination filed by the)	
CALIFORNIA TAXPAYERS')	[Docket No. 98-011]
ASSOCIATION, concerning)	
Sales and Use Tax)	November 3, 1999
Annotations 195.2000,)	
295.1740, 190.2543, 190.0777,)	Determination pursuant to
110.1440, 195.0360, 195.1480,)	Government Code Section 11340.5;
and 120.0660 contained in the)	Title 1, California Code of
Business Taxes Law Guide)	Regulations, Chapter 1, Article 3
issued by the STATE BOARD)	
OF EQUALIZATION ¹)	

Determination by: CHARLENE G. MATHIAS, Deputy Director

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SYNOPSIS ²

The Office of Administrative Law concludes that seven of eight tax annotations issued by the Board of Equalization are "regulations" which are invalid because they should have been, but were not, adopted pursuant to the Administrative Procedure Act. The remaining annotation appears on its face *not* to be a "regulation," but could in practice be utilized in such a way as to, in effect, amend a duly adopted provision of the California Code of Regulations, in which case this

annotation would be an invalid “regulation.” None of these annotations are exempt from the Administrative Procedure Act as “rulings of counsel.”

DECISION^{3, 4, 5, 6}

The California Taxpayers’ Association (“Cal-Tax”) has requested the Office of Administrative Law (“OAL”) to determine whether or not certain sales and use tax annotations contained in the Business Taxes Law Guide issued by the State Board of Equalization (“Board”) are “regulations” as defined in Government Code section 11342, subdivision (g), and are therefore invalid unless adopted as regulations and filed with the Secretary of State in accordance with the California Administrative Procedure Act (“APA”).⁷

The Office of Administrative Law finds that seven of the eight challenged annotations are “regulations” as defined in the APA, and are therefore invalid and unenforceable unless adopted as regulations and filed with the Secretary of State in accordance with the APA.⁸ The annotations that are “regulations” concern the taxability of sales of (a) paint used to paint labels; (b) structural plans; (c) building materials later stolen from a jobsite; (d) fish; (e) egg containers and (f) electronic files. The remaining annotation concerning transactions between road mix suppliers and contractors appears on its face not to be a “regulation,” but could possibly be utilized in such a way as to amend section 1521 of the California Code of Regulations (“CCR”), in which case this annotation would also be an invalid “regulation.”

DISCUSSION

I. BACKGROUND

The State Board of Equalization (“Board”) was created by former Article 13, section 9 of the California Constitution of 1879. Language establishing the Board is currently found in California Constitution, Article 13, section 17. The Board is charged with administering numerous tax programs, including the Sales and Use Tax, for the support of state and local governmental activities. The Board also has major responsibilities in providing rules and regulations governing the Property Tax. As an appellate body, the Board hears appeals in a number of different areas, including the Sales and Use Tax, Property Tax, the Personal Income Tax, and the Bank and Corporation Tax. The Board publishes and utilizes Sales and Use Tax

Annotations as a guide to the application of Sales and Use Tax statutes and regulations to specific transactions.

The requester is a non-profit taxpayer advocacy organization. It submitted a request for a regulatory determination to OAL on November 2, 1998, challenging eight sales and use tax annotations issued by the Board. OAL published notice of its active consideration of the request for determination on June 25, 1999, initiating a public comment period. Comments were submitted by the California Manufacturers Association. The Board submitted its response to the request for determination on August 2, 1999.

II. IS THE APA GENERALLY APPLICABLE TO THE QUASI-LEGISLATIVE ENACTMENTS OF THE BOARD OF EQUALIZATION?

The Board has been granted authority to adopt rules and regulations governing the Sales and Use Tax. Revenue and Taxation Code section 7051 provides:

“The board shall enforce the provisions of this part [Part 1 of Division 2 of the Revenue and Taxation Code – ‘Sales and Use Taxes’] and may prescribe, adopt, and enforce rules and regulations relating to the administration and enforcement of this part. The board may prescribe the extent to which any ruling or regulation shall be applied without retroactive effect.”

The APA applies to all state agencies, except those in the judicial or legislative branches.⁹ For purposes of the APA, Government Code section 11000 defines the term “state agency” as follows:

“As used in this title [Title 2, Government of the State of California (which title encompasses the APA)], ‘state agency’ includes every state office, officer, department, division, bureau, *board*, and commission.” [Emphasis added.]

The Board is in the executive branch of state government. Thus, APA rulemaking requirements generally apply to the Board.¹⁰ Its codified regulations are printed in the California Code of Regulations, Title 18, sections 1 through 7011.

III. DO THE CHALLENGED ANNOTATIONS CONTAIN “REGULATIONS” WITHIN THE MEANING OF GOVERNMENT CODE SECTION 11342?

Government Code section 11342, subdivision (g), defines “regulation” as:

“. . . *every* rule, regulation, order, or standard of general application *or* the amendment, supplement, or revision of any rule, regulation, order, or standard adopted by *any* state agency to implement, interpret, or make specific the law enforced or administered by it, or to govern its procedure. . . . [Emphasis added.]”

Government Code section 11340.5, authorizing OAL to determine whether agency rules are “regulations,” and thus subject to APA adoption requirements, provides in part:

“(a) *No* state agency shall issue, utilize, enforce, or attempt to enforce *any* guideline, criterion, bulletin, manual, instruction, order, standard of general application, or other rule, which is a [“]regulation[”] as defined in subdivision (g) of Section 11342, *unless* the guideline, criterion, bulletin, manual, instruction, order, standard of general application or other rule has been adopted as a regulation and filed with the Secretary of State pursuant to [the APA]. [Emphasis added.]”

In *Grier v. Kizer*,¹¹ the California Court of Appeal upheld OAL’s two-part test¹² as to whether a challenged agency rule is a “regulation” as defined in the key provision of Government Code section 11342, subdivision (g):

First, is the challenged rule either:

- a rule or standard of general application, *or*
- modification or supplement to such a rule?

Second, has the challenged rule been adopted by the agency to either:

- implement, interpret, or make specific the law enforced or administered by the agency, *or*

- govern the agency's procedure?

If an uncodified rule satisfies both parts of the two-part test, OAL must conclude that it is a “regulation” subject to the APA. In applying the two-part test, we are mindful of the admonition of the *Grier* court:

“ . . . because the Legislature adopted the APA to give interested persons the opportunity to provide input on proposed regulatory action (*Armistead*, . . . 22 Cal.3d at p. 204, 149 Cal.Rptr. 1, 583 P.2d 744), we are of the view that *any doubt as to the applicability of the APA's requirements should be resolved in favor of the APA.*¹³ [Emphasis added.]”

Three California Court of Appeal cases provide additional guidance on the proper approach to take when determining whether an agency rule is subject to the APA.

According to *Engelmann v. State Board of Education* (1991), agencies need not adopt as regulations those rules contained in “a statutory scheme which the Legislature has [already] established. . . .”¹⁴ But “to the extent [that] any of the [agency rules] depart from, or embellish upon, express statutory authorization and language, the [agency] will need to promulgate regulations. . . .”¹⁵

Similarly, agency rules properly promulgated *as regulations* (i.e., CCR provisions) cannot legally be “embellished upon” in administrative bulletins. For example, *Union of American Physicians and Dentists v. Kizer* (1990)¹⁶ held that a terse 24-word definition of “intermediate physician service” in a Medi-Cal regulation could not legally be supplemented by a lengthy seven-paragraph passage in an administrative bulletin that went “far beyond” the text of the duly adopted regulation.¹⁷ Statutes may legally be amended only through the legislative process; duly adopted regulations—generally speaking—may legally be amended only through the APA rulemaking process.

The third case, *State Water Resources Control Board v. Office of Administrative Law (Bay Planning Commission)* (1993), made clear that reviewing authorities are to focus on the *content* of the challenged agency rule, not the *label* placed on the rule by the agency:

“ . . . [The] Government Code . . . [is] careful to provide OAL authority over regulatory measures whether or not they are designated ‘regulations’ by the

relevant agency. In other words, *if it looks like a regulation, reads like a regulation, and acts like a regulation, it will be treated as a regulation whether or not the agency in question so labeled it. . . .* [Emphasis added.]”¹⁸

A. ARE THE CHALLENGED ANNOTATIONS RULES OR STANDARDS OF GENERAL APPLICATION?

For an agency policy to be a “standard of general application,” it need not apply to all citizens of the state. It is sufficient if the rule applies to members of a class, kind, or order.¹⁹ With this request we are asked to determine whether eight sales and use tax annotations are “regulations.”

The following provisions of the Sales and Use Tax law provide a general background necessary for understanding the application of the annotations challenged in this request.

Revenue and Taxation Code section 6051 imposes a sales tax upon the gross receipts of any retailer from the sale of all tangible personal property sold at retail in the State of California. For purposes of this tax, "sale" is broadly defined²⁰ to include, among other items, "[a]ny transfer of title or possession, exchange, or barter, conditional or otherwise, in any manner or by any means whatsoever, of tangible personal property for a consideration." Operating in conjunction with the sales tax is the use tax. Revenue and Taxation Code section 6201 imposes the use tax upon the storage, use, or other consumption in the State of California of tangible personal property purchased from any retailer.

Although exemptions from these taxes are set forth in many sections of the Revenue and Taxation Code, quite a few of these exemptions are compiled in Chapter 4, (commencing with section 6351) of Part 1 (Sales and Use Taxes) of Division 2. The Board has issued sales and use tax annotations to explain the proper application of sales and use tax. As we can readily see from the broad applicability of sales and uses taxes, any generally applicable exemptions from these taxes necessarily also have broad application to retail sales and use of personal property throughout the state.

The eight challenged sales and use tax annotations are listed below in the same order as the requester presented them to OAL:

- (1) “195.2000 **Paint** used to stencil product name on container treated as an exempt label, where container [is] re-painted upon each refilling. 12/13/51.”

The challenged rule indicates that paint used to make a label is not subject to sales tax, provided certain conditions are met. This is a rule that would apply to anyone selling or purchasing paint intended for use in this manner. Such persons constitute an open class.

- (2) “295.1740 **Structural Plans**. Charges made for ‘engineering fees, postage, labor of handling’ in furnishing structural plans sent to persons interested in building their own structures are subject to sales tax. 3/3/53.”

The annotation identifies a class of sales transactions that are subject to sales tax. It applies generally, in every sale of structural plans fitting the limitations set forth in the rule.

- (3) “190.2543 **Theft of Materials**. A construction contractor properly purchases ‘materials’ for resale and places the goods in resale inventory. Some of the materials are delivered to the jobsite from which they are stolen. A credit may be allowed for any use tax reported and paid on such ‘materials’ when it was allocated to the job by the contractor, provided the theft occurred prior to the time the contractor had actually made use of the material by incorporating them into the real estate or otherwise making a physical use of the materials. 11/13/64.”

The annotation on theft of material from a jobsite allows for credit on use tax paid for such materials, provided certain conditions are met. Although the annotation makes use of a particular situation as an example, it describes a general rule that would apply in every circumstance where the pertinent facts fit the example.

- (4) “190.0777 **Road Mix Suppliers**. A prime contractor has a contract to furnish and install road mix material. The prime contractor subcontracts with a road mix supplier to furnish and install the road mix material. The road mix supplier then hires or subcontracts back with the prime contractor to install the road mix material.

“Such agreements attempt to depict the supplier as a construction contractor who is the consumer of the material rather than being the retailer. For sales and use tax purposes, such subcontracting agreements are without substance and will be disregarded. Road mix suppliers will remain the retailers of the materials they provide to the prime contractors and are liable for the sales tax measured by the selling price of the material to the contractor. 8/28/91; 9/3/91.”

Like the annotation on the taxability of stolen construction materials, the annotation on road mix suppliers and contractors who actually install the road mix makes use of an example. It is hypothetical,²¹ and is intended to state a generally applicable policy, namely: “such subcontracting agreements are without substance and will be disregarded.” The “road mix suppliers will remain the retailers.”

(5) “110.1440 **Zoos.** Sales of fish to aquariums and zoos to feed porpoises, whales, seals, and other forms of animal life which do not ordinarily constitute food for human consumption are subject to sales tax. 9/25/67.”

Clearly, this annotation would apply generally to sales of fish to aquariums and zoos for the purposes specified.

(6) “195.0360 **Egg Containers.** Egg containers which are unsold with their contents and are not returned, may not qualify for the nonreturnable container exemption if they are first used by the producer or supplier. Thus, sales of such egg containers as cases, fillers, flats, filler flats and trays to producers who first use them for transporting eggs to processors for grading and cleaning, are taxable, even though such containers are subsequently repacked with eggs which are then sold with the containers.

“Containers repurchased by a seller for which the seller did not make a deposit charge do not lose their status as exempt nonreturnable containers, if the seller does not repurchase more than 50 percent of all nonreturnable containers he sells. 9/25/67.”

(7) “195.1480 **Egg Containers.** Egg containers which are used by producers to transport eggs to processors and are customarily returned, are taxable returnable containers. 9/25/67.”

Both of the annotations on egg containers describe the applicability of tax to the purchase and use of such containers. The rules they contain are stated in language that indicates general application to all producers and suppliers of eggs and sellers of eggs who repurchase containers.

(8) “120.0660 **Transfer on Disk** Tax applies to the amount charged for design, typography, page layout, production and transfer of electronic files if they are transferred from designer to client on disk (magnetic media), even if title to this magnetic media is not transferred.

“However, tax does not apply to the production or transfer of those same electronic files transferred to the client via modem. 9/19/95.”

This annotation is stated in language that indicates it applies to all transactions which involve the sale of an electronic file by its designer to a customer. In summary, all of the eight challenged annotations contain rules or standards that apply generally.

B. DO THE CHALLENGED ANNOTATIONS INTERPRET, IMPLEMENT, OR MAKE SPECIFIC THE LAW ENFORCED OR ADMINISTERED BY THE AGENCY OR GOVERN THE AGENCY’S PROCEDURE?

The Board is authorized by Revenue and Taxation Code section 7051 to “prescribe, adopt, and enforce rules and regulations relating to the administration and enforcement of [the Sales and Use Tax law].”

(1) The first challenged annotation concerns the taxability of paint used to make labels. The requester contends that the exemption for paint interprets Revenue and Taxation Code section 6364 and section 1589 of Title 18 of the CCR. Section 6364 provides an exemption from sales and use tax for containers that meet particular requirements. Section 1589, subdivision (b), paragraph (2), provides as follows:

“Labels. Tax does not apply to sales of labels or nameplates if:

(A) The purchaser affixes them to property to be sold and sells them along with and as a part of such property, as, for example, sales of nameplates

of manufacturers or producers which are permanently affixed to each unit of products sold, such as automobiles and machinery.

- (B) The purchaser affixes them to nonreturnable containers of property to be sold, or to returnable containers of such property if a new label is affixed to the container each time it is refilled. Examples are sales of labels to be affixed to fruit boxes, cans, bottles and packing cases, to growers, packers, bottlers and others who place the contents in the containers.”

The challenged annotation provides:

“195.2000 **Paint** used to stencil product name on container treated as an exempt label, where container [is] re-painted upon each refilling. 12/13/51.”

It is readily apparent that the codified regulation (section 1589) operates generally to make labels exempt from sales and use tax. It is also clear that this section does not mention paint used to make labels on containers. We note that the paint does not actually become a label until it is applied to the product container. Thus the annotation *interprets* the tax exemption for the sale of labels in a manner broad enough to include the sale of paint to be used for making a label. The annotation is therefore a “regulation.”

(2) The second challenged annotation concerns the taxability of the sale of structural plans. The requester argues that it interprets the definition of “gross receipts” set forth in Revenue and Taxation Code section 6012. In part, section 6012 provides as follows:

“(a) ‘Gross receipts’ mean the total amount of the sale or lease, or rental price, as the case may be, of the retail sales of retailers, valued in money, whether received in money or otherwise, without any deduction on account of any of the following:

- (1) . . .
- (2) The cost of the materials used, labor or service cost, interest paid, losses or any other expense.
- (3) The cost of transportation of the property, except as excluded by other provisions of this section.”

“(b) The total amount of the sale or lease or rental price includes all of the following:

(1) Any services that are a part of the sale.”

“(c) ‘Gross receipts’ do not include any of the following:

(1) – (6) . . .

(7) Separately stated charges for transportation from the retailer’s place of business or other point from which shipment is made directly to the purchaser, but the exclusion shall not exceed a reasonable charge for transportation by facilities of the retailer or the cost to the retailer of transportation by other than facilities of the retailer. However, if the transportation is by facilities of the retailer, or the property is sold for a delivered price, this exclusion shall be applicable solely with respect to transportation which occurs after the sale of the property is made to the purchaser.”

The challenged annotation provides:

“295.1740 **Structural Plans.** Charges made for ‘engineering fees, postage, labor of handling’ in furnishing structural plans sent to persons interested in building their own structures are subject to sales tax. 3/3/53.”

The provision explaining that charges for engineering fees are subject to sales tax appears to be the only legally tenable interpretation²² of section 6012, subdivision (a)(2), above, that includes service costs in gross receipts. Similarly, including charges for labor of handling in gross receipts subject to sales tax is required by subdivision (b)(1) above. The *annotation* also includes postage in the measure of gross receipts. The *statute* does not specifically mention postage, although it does mention charges for transportation, indicating that they are not included in gross receipts, when separately stated. We are not aware of any codified regulation that includes *all* postage in the measure of gross receipts. Under section 6012, subdivision (c)(7), separately stated charges for postage would appear to be excluded from “gross receipts.” The annotation thus limits the tax exemption for transportation charges, indicating that it does not apply to postage paid for the shipment of structural plans to persons interested in building their own structures, even when such charges are separately stated. This portion of the annotation is therefore a “regulation.”

(3) The third challenged annotation concerns the taxability of stolen construction materials. The requester claims that the annotation interprets section 1521 of Title 18 of the CCR. This section, entitled “Construction Contractors,” is a lengthy regulation. It includes, in subdivision (a)(4), the definition of the term “materials,” which provides:

“Materials. ‘Materials’ means and includes construction materials and components, and other tangible personal property incorporated into, attached to, or affixed to, real property by contractors in the performance of a construction contract and which, when combined with other tangible personal property, loses its identity to become an integral and inseparable part of the real property. A list of typical items regarded as materials is set forth in Appendix A.”

Subdivision (b), paragraph (2)(a)(1) of section 1521 sets forth the general rule on the taxability of materials used by construction contractors. It provides, in part:

“In General. Construction contractors are consumers of materials which they furnish and install in the performance of construction contracts. Either sales tax or use tax applies with respect to the sale of the materials to or the use of the materials by the construction contractor.”

The challenged annotation provides:

“190.2543 **Theft of Materials.** A construction contractor properly purchases ‘materials’ for resale and places the goods in resale inventory. Some of the materials are delivered to the jobsite from which they are stolen. A credit may be allowed for any use tax reported and paid on such ‘materials’ when it was allocated to the job by the contractor, provided the theft occurred prior to the time the contractor had actually made use of the material by incorporating them into the real estate or otherwise making a physical use of the materials. 11/13/64.”

From the foregoing, we see that the annotation explains the applicability of tax when some of those materials are stolen, and limits the allowance of credit for stolen items to those situations where the theft occurred prior to the incorporation of the materials into the real estate. Allowing credit for stolen materials could possibly pass muster as the only legally tenable interpretation of the definition of

construction materials. Under such an analysis the stolen goods did not become an inseparable part of the real estate, a fact made plain by their theft, and are not “materials” as defined in section 1521, subdivision (a)(4). On this basis, we might conclude that language of the annotation allowing for credit is not a “regulation.”

Nevertheless, the annotation’s *limitation of credit* to situations where the contractor did not “make use of the material by incorporating them into the real estate” is clearly not the only legally tenable interpretation of section 1521. Credit for stolen materials is not a part of section 1521. The decision to deny credit whenever the contractor, by making physical use of the materials, attempted to make the materials a permanent part of the real estate is *an interpretation* of section 1521. The annotation is therefore a “regulation.”

(4) The fourth challenged annotation states a general rule designed to penetrate the smoke of a complex subcontracting arrangement between a road mix supplier and a road building contractor. It provides that the road mix supplier remains liable for the sales or use tax. The requester contends that this annotation interprets the meaning of the term “retailer” under Revenue and Taxation Code section 6015, and, like the annotation on stolen construction materials, section 1521 of Title 18 of the CCR. Section 6015 provides, in part:

“(a) ‘Retailer’ includes:

- (1) Every seller who makes any retail sale or sales of tangible personal property, and every person engaged in the business of making retail sales at auction of tangible personal property owned by the person or others.
- (2) Every person engaged in the business of making sales for storage, use, or other consumption or in the business of making sales at auction of tangible personal property owned by the person or others for storage, use, or other consumption.”

The challenged annotation provides:

“190.0777 **Road Mix Suppliers.** A prime contractor has a contract to furnish and install road mix material. The prime contractor subcontracts with a road mix supplier to furnish and install the road mix material. The

road mix supplier then hires or subcontracts back with the prime contractor to install the road mix material.

“Such agreements attempt to depict the supplier as a construction contractor who is the consumer of the material rather than being the retailer. For sales and use tax purposes, such subcontracting agreements are without substance and will be disregarded. Road mix suppliers will remain the retailers of the materials they provide to the prime contractors and are liable for the sales tax measured by the selling price of the material to the contractor. 8/28/91; 9/3/91.”

The annotation applies the definition of retailer from section 6015 to resolve the question of whether the road mix supplier or the prime contractor is liable for collection of the sales or use tax, an arrangement between the parties to disguise the real facts notwithstanding. Under this analysis, the challenged annotation is not a “regulation.” It is possible, however, that the challenged annotation is intended to interpret, implement or make specific Title 18 of the CCR, section 1521, subdivision (b), paragraph (2)(A)(2), which provides, in part:

“When Contractor is Seller. A construction contractor may contract to sell materials and also to install the materials sold. If the contract explicitly provides for the transfer of title to the materials prior to the time the materials are installed, and separately states the sale price of the materials, exclusive of the charge for installation, the contractor will be deemed to be the retailer of the materials.”

Section 1521 allows a contractor to be a retailer of the materials, so long as the contract explicitly provides for the transfer of title to the materials prior to the time the materials are installed, and separately states the sale price of the materials. If the rule of the annotation makes it necessary for road mix suppliers to collect sales tax on all sales of road mix to contractors, then the annotation would likely make it impossible for contractors to purchase road mix tax free and then act as retailers of road mix. If the annotation is interpreted in this manner, it has the effect of amending section 1521 by excluding contractors from the retailing of road mix, and is a “regulation.” Without additional information concerning use of the annotation by the Board, it is impossible for OAL to completely resolve the question.

OAL concludes that if the annotation simply applies the statutory definition of “retailer” to a set of facts and does not interpret, implement, or make specific Title 18, CCR, section 1521, then the challenged annotation is not a “regulation.”

(5) The fifth challenged annotation concerns the taxability of fish sold as animal feed to zoos and aquariums. The requester explains that the annotation interprets section 1587 of Title 18 of the CCR. Section 1587, subdivision (a) provides, in part:

“Animal Life. Tax does not apply to sales of any form of animal life of a kind, the products of which ordinarily constitute food for human consumption (food animals), as for example, cattle, sheep, swine, baby chicks, hatching eggs, *fish*, and bees. . . . Tax does apply, however, to retail sales (including sales for breeding purposes) of any form of animal life not of such a kind (non-food animals), as for example, cats, dogs, horses, mink, and canaries.

Section 1587, subdivision (b), paragraph (2)(A), provides, in part:

“In General. Tax does not apply to sales of feed for food animals or for any non-food animals which are to be sold in the regular course of business.”

Thus we see that section 1587 does not provide a clear answer to the question of whether sales of fish to aquariums and zoos for animal feed are taxable. On one hand, subdivision (a) seems to acknowledge that sales of fish are tax free, because fish *ordinarily* constitute food for human consumption. On the other hand, we know that the fish in question are not for human consumption, a fact that suggests the sale might be taxable under the second provision of subdivision (a). Everyone knows that the aquarium and zoo animals are not food animals and they, most likely, will not be sold in the regular course of business, so perhaps, under (b), tax applies. The challenged annotation provides:

“110.1440 **Zoos.** Sales of fish to aquariums and zoos to feed porpoises, whales, seals, and other forms of animal life which do not ordinarily constitute food for human consumption are subject to sales tax. 9/25/67.”

By definitively resolving these questions, the annotation interprets section 1587 and is therefore a “regulation.”

(6/7) The sixth and seventh challenged annotations concern the taxability of egg containers. The requester states that each annotation “asserts a rule that interprets the meaning of the “container” exemption provided for in Revenue and Taxation Code Section 6364 and Regulation 1589.” As noted in the discussion of the first challenged annotation, section 6364 provides an exemption from sales and use tax for containers that meet particular requirements. It provides:

“There are exempted from the taxes imposed by this part, the gross receipts from sales of and the storage, use, or other consumption in the State of:

- (a) Nonreturnable containers when sold without the contents to persons who place the contents in the container and sell the contents together with the container.
- (b) Containers when sold with the contents if the sales price of the contents is not required to be included in the measure of the taxes imposed by this part.
- (c) Returnable containers when sold with the contents in connection with a retail sale of the contents or when resold for refilling. As used herein the term ‘returnable containers’ means containers of a kind customarily returned by the buyer of the contents for reuse. All other containers are ‘nonreturnable containers.’”

As noted in the discussion of the first challenged annotation, section 1589 is a regulation that specifies the applicability of sales and use tax to containers and labels. Its provisions concerning containers are lengthy, and it is unnecessary to include them all here. The two challenged annotations concerning egg containers indicate that the container exemption from tax is unavailable when a producer or supplier first makes use of the container for transporting eggs to processors. They provide:

“195.0360 **Egg Containers.** Egg containers which are unsold with their contents and are not returned, may not qualify for the nonreturnable container exemption if they are first used by the producer or supplier. Thus, sales of such egg containers as cases, fillers, flats, filler flats and trays to producers who first use them for transporting eggs to processors for grading and cleaning, are taxable, even though such containers are subsequently repacked with eggs which are then sold with the containers.

“Containers repurchased by a seller for which the seller did not make a deposit charge do not lose their status as exempt nonreturnable containers, if the seller does not repurchase more than 50 percent of all nonreturnable containers he sells. 9/25/67.”

“195.1480 **Egg Containers.** Egg containers which are used by producers to transport eggs to processors and are customarily returned, are taxable returnable containers. 9/25/67.”

The limitation which denies tax exempt status when a container is first used for transporting eggs to processors, even if the container is later used in a tax exempt manner, is found neither in Revenue and Taxation Code section 6364 above, nor in section 1589 of Title 18 of the CCR. It interprets these laws by specifying the applicability of sales and use tax in a situation they do not address. Similarly, the rule on repurchase of containers and its 50 percent limitation are not contained in the applicable statutes or regulations properly adopted pursuant to the APA. The annotation is therefore an interpretation of law and a “regulation.”

(8) The eighth and final challenged annotation concerns the taxability of electronic files transferred on computer disks. The requester contends that the annotation interprets section 1502 of Title 18 of the CCR. This is a lengthy regulation that specifies the applicability of sales tax to computers, computer programs, and data processing services. The subject is rather complicated. Generally, tax applies to a sale of tangible property, and not to the furnishing of a service. For this reason, the analysis usually focuses on the question of whether the transfer of a program is accomplished by the transfer of a tangible item, such as a disk, although this is not determinative in every case. The challenged annotation provides:

“120.0660 **Transfer on Disk** Tax applies to the amount charged for design, typography, page layout, production and transfer of electronic files if they are transferred from designer to client on disk (magnetic media), even if title to this magnetic media is not transferred.

“However, tax does not apply to the production or transfer of those same electronic files transferred to the client via modem. 9/19/95.”

The mention in the annotation of a “designer” as the person selling electronic files suggests that the annotation is intended to apply to custom computer programs, as

defined in subdivision (b) of section 1502 of Title 18 of the CCR. Section 1502, subdivision (f), paragraph (2)(A), which specifies the applicability of sales tax to custom computer programs, indicates that tax does not apply, subject to certain limitations. It provides, in part:

“Tax does not apply to the sale or lease of a custom computer program, other than a basic operational program, regardless of the form in which the program is transferred.”

The first sentence of the challenged annotation has an effect different from the regulation, although it may be that we do not fully understand section 1502. In any event, the first sentence of the annotation interprets the confusing rules on the taxability of computer programs. The second sentence of the annotation restates a provision of subdivision (f), paragraph (1)(D), which provides, in part:

“The sale or lease of a prewritten program is not a taxable transaction if the program is transferred by remote telecommunications from the seller’s place of business, to or through the purchaser’s computer and the purchaser does not obtain possession of any tangible personal property, such as storage media, in the transaction.”

In other words, the first sentence of this annotation on the taxability of computer programs includes a “regulation,” but the second sentence is not a “regulation” because it simply restates a provision of law.

In summary, seven of the challenged annotations contain “regulations” within the meaning of Government Code section 11342, subdivision (g). The remaining annotation concerning transactions between road mix suppliers and contractors appears on its face not to be a “regulation,” but could possibly be utilized in such a way as to amend section 1521 of the California Code of Regulations, in which case this annotation would also be an invalid “regulation.”

IV. DO THE CHALLENGED ANNOTATIONS FOUND TO BE “REGULATIONS” FALL WITHIN ANY RECOGNIZED EXEMPTION FROM APA REQUIREMENTS?

Generally, all “regulations” issued by state agencies are required to be adopted pursuant to the APA, unless expressly exempted by statute.²³ In *United Systems of*

Arkansas v. Stamison (1998),²⁴ the California Court of Appeal rejected an argument by the Director of the Department of General Services that language in the Public Contract Code had the effect of exempting rules governing bid protests from the APA. According to the *Stamison* Court:

“When the Legislature has intended to exempt regulations from the APA, it has done so by clear, unequivocal language. (See, e.g., Gov. Code, section 16487 [‘The State Controller may establish procedures for the purpose of carrying out the purposes set forth in Section 16485. These procedures are exempt from the Administrative Procedure Act.’]; Gov. Code, section 18211 [‘Regulations adopted by the State Personnel Board are exempt from the Administrative Procedure Act’]; Labor Code, section 1185 [orders of Industrial Welfare Commission ‘expressly exempted’ from the APA].) [Emphasis added.]”²⁵

OAL describes express statutory APA exemptions by dividing them into two categories: special and general. Special express statutory exemptions typically: (1) apply only to a portion of one agency’s “regulations” and (2) are found in that agency’s enabling act. General express statutory exemptions typically: (1) apply across the board to all state agencies and (2) are found in the APA. An example of a special express exemption is Penal Code section 5058, subdivision (d)(1), which exempts pilot programs of the Department of Corrections under specified conditions. An example of a general express exemption is Government Code section 11342, subdivision (g), part of which exempts “internal management” regulations of all state agencies from the APA.

A. DO THE CHALLENGED ANNOTATIONS FALL WITHIN ANY SPECIAL EXPRESS APA EXEMPTION?

In 1983, the Legislature elected to exempt “legal rulings of counsel” from APA requirements.²⁶ Government Code section 11342, subdivision (g), provides in part that:

“ ‘Regulation’ does not mean or include legal rulings of counsel issued by the Franchise Tax Board or State Board of Equalization. . . .”

We classify this exemption as special, rather than general, even though it is set forth in the APA, because it is limited to the two named taxing agencies. In 1986,

we examined the scope of this exemption in a determination involving the same parties as the present determination.²⁷ In 1986, the challenged rule was *County Assessors Letter No. 85/128*, which had been issued by the Board to promote uniformity in assessment practices throughout the state. In its 1986 response to the request for determination, the Board argued that the challenged letter was a legal ruling of counsel, and thus, exempt from the APA. At that time, the Board supported its argument with the following facts:

- (1) The letter had been prepared by the Board's Chief Counsel;
- (2) It was a statement of legal principles, including analysis supported by case law and other interpretive materials;
- (3) The analysis dealt with the application of specific provisions of law to specifically described types of factual situations;
- (4) It said essentially the same thing as two rulings of counsel dated July 11, 1980 and December 4, 1985.

The Board's analysis suggested that items (1) through (3) were characteristics of a ruling of counsel. In the 1986 determination, OAL concluded that the challenged letter to assessors did not measure up as a ruling of counsel. It had not been signed by an attorney and was not an actual ruling from a particular case.

The annotations challenged in the current request likewise lack the documentation that would establish them as legal rulings of counsel.²⁸ Given the remedial nature of the APA, exemptions must be narrowly construed, and it would be improper to recognize a rule as exempt when the requisites have not been documented in a record, or have been lost.²⁹ The requester has noted, and the Board has not disagreed, that all the challenged annotations lack legal analysis, that some are not supported by documentation identifying the context in which they were issued, and at least one was not prepared by an attorney.

The Board is in the process of adopting a regulation to specify the necessary elements in a legal ruling of counsel.³⁰ In its reply, the Board acknowledges that the annotations do not contain all of the elements that would be required under the proposed regulation.³¹ The Board is in the process of deleting all eight of the challenged annotations from the Business Taxes Law Guide.

B. DO THE CHALLENGED ANNOTATIONS FALL WITHIN ANY GENERAL EXPRESS APA EXEMPTION?

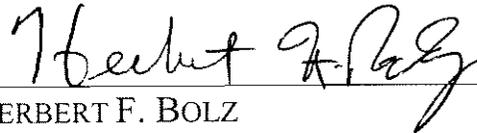
Rules concerning certain specified activities of state agencies are not subject to the procedural requirements of the APA. The Board does not argue that a general express exception applies. Our independent research having disclosed none, we conclude that no general express APA exemption is applicable.

OAL concludes that at least seven of the eight sales and use tax annotations contained in the Business Taxes Law Guide issued by the Board are “regulations” as defined in Government Code section 11342, subdivision (g), and that none of the available statutory exceptions apply to these challenged annotations.

CONCLUSION

For the reasons set forth above, OAL concludes that seven of the eight challenged tax annotations issued by the Board contain general rules that are "regulations" subject to the APA. The remaining annotation appears on its face *not* to be a "regulation," but could in practice be utilized in such a way as to, in effect, amend a duly adopted provision of the California Code of Regulations, in which case this annotation would be an invalid "regulation." The "regulations" are not exempt from the APA as "rulings of counsel."

DATE: November 3, 1999



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ENDNOTES

1. This request for determination was received from Wm. Gregory Turner, General Counsel of the California Taxpayers' Association (Cal-Tax), 921 Eleventh Street, Suite 800, Sacramento, California 95814 (916) 441-0490 on November 4, 1998, and accepted by OAL. The Board of Equalization was represented by Timothy W. Boyer, Chief Counsel, Board of Equalization, Legal Division - MIC 82, 450 N Street, Sacramento, CA 95814 (916) 445-4380.
2. This determination may be cited as "**1999 OAL Determination No. 26.**"
3. If an uncodified agency rule is found to violate Government Code section 11340.5, subdivision (a), the rule in question may be validated by formal adoption "as a *regulation*" (Government Code section 11340.5, subd. (b); emphasis added) or by incorporation in a statutory or constitutional provision. See also *California Coastal Commission v. Quanta Investment Corporation* (1980) 113 Cal.App.3d 579, 170 Cal.Rptr. 263 (appellate court authoritatively construed statute, validating challenged agency interpretation of statute.) An agency rule found to violate the APA could also simply be rescinded.
4. OAL does not review alleged underground regulations for compliance with the APA's six substantive standards of Necessity, Authority, Clarity, Consistency, Reference, and Nonduplication. However, in the event regulations were proposed by the Department under the APA, OAL would review the *proposed* regulations for compliance with the six statutory criteria. (Government Code sections 11349 and 11349.1.)
5. Title 1, California Code of Regulations ("CCR") (formerly known as the "California Administrative Code"), subsection 121 (a), provides:

" '*Determination*' means a finding by OAL as to whether a state agency rule is a 'regulation,' as defined in Government Code section 11342(g), which is *invalid and unenforceable* unless

(1) it has been adopted as a regulation and filed with the Secretary of State pursuant to the APA, or,

(2) it has been exempted by statute from the requirements of the APA. [Emphasis added.]"

See *Grier v. Kizer* (1990) 219 Cal.App.3d 422, 268 Cal.Rptr. 244, review denied (finding that Department of Health Services' audit method was *invalid* because it was an underground regulation which should be adopted pursuant to the APA); and *Planned Parenthood Affiliates of California v. Swoap* (1985) 173 Cal.App.3d 1187, 1195, n. 11,

219 Cal.Rptr. 664, 673, n. 11 (citing Gov. Code sec. 11347.5 (now 11340.5) in support of finding that uncodified agency rule which constituted a “regulation” under Gov. Code sec. 11342, subd. (b)—now subd. (g)—yet had not been adopted pursuant to the APA, was “invalid”). We note that a 1996 California Supreme Court case stated that it “disapproved” of *Grier* in part. *Tidewater Marine Western, Inc. v. Bradshaw* (1996) 14 Cal.4th 557, 577, 59 Cal.Rptr. 2d 186, 198. *Grier*, however, is still authoritative, except as specified by the *Tidewater* court. *Tidewater* itself, in discussing which agency rules are subject to the APA, referred to “the two-part test of the Office of Administrative Law,” citing *Union of American Physicians & Dentists v. Kizer* (1990) 223 Cal.App.3d 490, 497, 272 Cal.Rptr. 886, a case which quotes the test from *Grier v. Kizer*.

6. *OAL Determinations Entitled to Great Weight in Court*

The California Court of Appeal has held that a statistical extrapolation rule utilized by the Department of Health Services in Medi-Cal audits must be adopted pursuant to the APA. *Grier v. Kizer* (1990) 219 Cal.App.3d 422, 268 Cal.Rptr. 244, disapproved on other grounds in *Tidewater*. Prior to this court decision, OAL had been requested to determine whether or not this Medi-Cal audit rule met the definition of “regulation” as found in Government Code section 11342, subdivision (b) (now subd. (g)), and therefore was required to be adopted pursuant to the APA. Pursuant to Government Code section 11347.5 (now 11340.5), OAL issued a determination concluding that the audit rule met the definition of “regulation,” and therefore was subject to APA requirements. **1987 OAL Determination No. 10**, CRNR 96, No. 8-Z, February 23, 1996, p. 293. The *Grier* court concurred with OAL’s conclusion, stating that:

“Review of [the trial court’s] decision is a question of law for this court’s independent determination, namely, whether the Department’s use of an audit method based on probability sampling and statistical extrapolation constitutes a regulation within the meaning of section 11342, subdivision (b) [now subd. (g)]. [Citations.]” (219 Cal.App.3d at p. 434, 268 Cal.Rptr. at p. 251.)

Concerning the treatment of **1987 OAL Determination No. 10**, which was submitted for its consideration in the case, the court further found:

“While the issue ultimately is one of law for this court, ‘the contemporaneous administrative construction of [a statute] by those charged with its enforcement and interpretation is *entitled to great weight*, and courts generally will not depart from such construction unless it is clearly erroneous or unauthorized. [Citations.]’ [Citations.] [Par.] Because [Government Code] section 11347.5, [now 11340.5] subdivision (b), charges the OAL with interpreting whether an agency rule is a regulation as defined in [Government Code] section 11342, subdivision (b) [now subd. (g)], *we accord its determination due consideration.* [*Id.*; emphasis added.]”

See also *Union of American Physicians & Dentists v. Kizer* (1990) 223 Cal.App.3d 490, 497, 272 Cal.Rptr. 886 (same holding) and note 5 of **1990 OAL Determination No. 4**, California Regulatory Notice Register 90, No. 10-Z, March 9, 1990, p. 384, at p. 391 (reasons for according due deference consideration to OAL determinations).

7. We refer to the portion of the APA which concerns rulemaking by state agencies: Chapter 3.5 of Part 1 (“Office of Administrative Law”) of Division 3 of Title 2 of the Government Code. Sections 11340 through 11356, Chapters 4 and 5, also part of the APA, do not concern rulemaking.

8. According to Government Code section 11370:

“Chapter 3.5 (commencing with Section 11340), Chapter 4 (commencing with Section 11370), Chapter 4.5 (commencing with Section 11400, and Chapter 5 (commencing with Section 11500) constitute, and may be cited as, the *Administrative Procedure Act*. [Emphasis added.]”

OAL refers to the portion of the APA which concerns rulemaking by state agencies: Chapter 3.5 of Part 1 (“Administrative Regulations and Rulemaking”) of Division 3 of Title 2 of the Government Code, sections 11340 through 11359.

9. Government Code section 11342, subdivision (a).

10. See *Winzler & Kelly v. Department of Industrial Relations* (1981) 121 Cal.App.3d 120, 126-128, 175 Cal.Rptr. 744, 746-747 (unless “expressly” or “specifically” exempted, all state agencies not in legislative or judicial branch must comply with rulemaking part of the APA when engaged in quasi-legislative activities); *Poschman v. Dumke* (1973) 31 Cal.App.3d 932, 942, 107 Cal.Rptr. 596, 603 (agency created by Legislature is subject to and must comply with APA).

11. (1990) 219 Cal.App.3d 422, 440, 268 Cal.Rptr. 244, 251. OAL notes that a 1996 California Supreme Court case stated that it “disapproved” of Grier in part. *Tidewater Marine Western, Inc. v. Bradshaw* (1996) 14 Cal.4th 557, 577. Grier, however, is still good law, except as specified by the *Tidewater* court. Courts may cite cases which have been disapproved on other grounds. For instance, in *Doe v. Wilson* (1997) 57 Cal.App.4th 296, 67 Cal.Rptr.2d 187, 197, the California Court of Appeal, First District, Division 5 cited *Poschman v. Dumke* (1973) 31 Cal.App.3d 932, 107 Cal.Rptr. 596, on one point, even though *Poschman* had been expressly disapproved on another point nineteen years earlier by the California Supreme Court in *Armistead v. State Personnel Board* (1978) 22 Cal.3d 198, 204 n. 3, 149 Cal.Rptr. 1, 3 n. 3. Similarly, in *Economic Empowerment Foundation v. Quackenbush* (1997) 57 Cal.App.4th 677, 67 Cal.Rptr.2d 323, 332, the California Court of Appeal, First District, Division 4, nine months after *Tidewater*, cited

Grier v. Kizer as a distinguishable case on the issue of the futility exception to the exhaustion of administrative remedies requirement.

Tidewater itself, in discussing which agency rules are subject to the APA, referred to “the two-part test of the Office of Administrative Law,” citing *Union of American Physicians & Dentists v. Kizer* (1990) 223 Cal.App.3d 490, 497, 272 Cal.Rptr. 886, a case which quotes the test from *Grier v. Kizer*.

12. The *Grier* Court stated:

“The OAL’s analysis set forth a two-part test: ‘First, is the informal rule either a rule or standard of general application or a modification or supplement to such a rule? [Para.] Second, does the informal rule either implement, interpret, or make specific the law enforced by the agency or govern the agency’s procedure?’ (1987 OAL Determination No. 10, . . . slip op’n., at p. 8.) [*Grier*, disapproved on other grounds in *Tidewater*].”

OAL’s wording of the two-part test, drawn from Government Code section 11342, has been modified slightly over the years. The cited OAL opinion—**1987 OAL Determination No. 10**—was published in California Regulatory Notice Register 96, No. 8-Z, February 23, 1996, p. 292.

13. (1990) 219 Cal.App.3d 422, 438, 268 Cal.Rptr. 244, 253. The same point is made in *United Systems of Arkansas v. Stamison* (1998) 63 Cal.App.4th 1001,1010, 74 Cal.Rptr.2d 407, 412, review denied.
14. 2 Cal.App.4th 47, 62, 3 Cal.Rptr.2d 264, 275, review denied.
15. *Id.*
16. 223 Cal.App.3d 490, 501, 272 Cal.Rptr. 886, 891.
17. *Id.*
18. (1993) 12 Cal.App.4th 697, 702, 16 Cal.Rptr.2d 25, 28.
19. *Roth v. Department of Veteran Affairs* (1980) 110 Cal.App.3d 622, 167 Cal.Rptr. 552. See *Faulkner v. California Toll Bridge Authority* (1953) 40 Cal.2d 317, 323-324 (standard of general application applies to all members of any open class).
20. Revenue and Taxation Code section 6006.

- 21 Note that the example is not the ruling on a particular case. It states a standard intended for general application in all circumstances where the contractual arrangement is as described in the example.
- 22 Where a standard utilized by an agency is the only legally tenable interpretation of the law administered by the agency, it follows that in utilizing the standard, the agency has not interpreted, implemented, or made specific that law. See *Grier v. Kizer* (1990) 219 Cal.App.3d 422, 268 Cal.Rptr. 244, 254.
23. Government Code section 11346.
24. 63 Cal.App.4th 1001, 1010, 74 Cal.Rptr.2d 407, 411-12, review denied.
25. 63 Cal.App.4th at 1010, 74 Cal.Rptr.2d at 411.
26. See Statutes of 1983, Chapter 1080, section 1, amending Government Code section 11342, subdivision (b).
26. *Natural Resources Defense Council v. Arcata National Corporation* (1976) 59 Cal.App.3d 959, 965, 131 Cal.Rptr. 172 (harmonize different statutes to give effect to all).
27. See 1986 OAL Determination No. 3 (State Board of Equalization, May 28, 1986; Docket No. 85-004), California Administrative Notice Register 86, No. 24-Z, June 13, 1986, p. B-26—B-27; looseleaf version, p. 15.
- 28 The requester has asked OAL to “establish substantive guidelines for what constitutes a legal ruling of counsel under Section 11342(g).” The requester has suggested :

“The structure for a legal ruling of counsel should contain seven basic elements: (1) a clear and concise rendition of the relevant facts; (2) a statement of the relevant issue presented; (3) a summary of all relevant statutory and regulatory law as well as any judicial or administrative precedent; (4) an analysis which thoroughly applies the law to the facts; and (5) a conclusion supported by the analysis. It is essential that the analysis contained in the “legal ruling of counsel” be thorough and its reasoning valid.[FN] Additionally, (6) such opinion must be drafted and signed by BOE counsel and (7) ensure that both the summary (the annotation) and the ‘back-up’ are readily available for public inspection.”

Like other state agencies, OAL is subject to the APA. OAL cannot lawfully utilize guidelines such as those recommended by the requester to establish new standards for rulings of counsel in a regulatory determination. Nevertheless, please note that this

matter is being addressed by the Board, which is in the process of adopting standards pursuant to the APA for its own rulings of counsel.

- 29 In 1986 OAL Determination No. 3, p. 16, Board of Equalization, May 28, 1986, Docket No. 85-004, (CANR 86, No. 24-Z, June 13, 1986, p. B-18), OAL addressed the Board's arguments (from 1986) in favor of a broad reading of rulings of counsel exemption. OAL wrote:

“Under the Board’s definition of the statutory term, [ruling of counsel] the exception swallows the rule. Despite other statutory requirements to the contrary, the Board would be free to dress up any tax-related ‘policy’ as a ‘legal ruling of counsel’ and thus evade APA notice and public comment requirements. Mindful of the *Armistead* court’s comment about persistent agency efforts to evade APA requirements, we are determined to carry out the intent of the Legislature as expressed in all pertinent statutes and will not permit an overbroad interpretation of one particular phrase to defeat larger legislative purposes.”

- 30 Notice of the proposed rulemaking was published in CRNR 99, No. 34- Z, August 20, 1999, p. 1641. The hearing was scheduled for October 6, 1999.

- 31 According to the Board’s reply, under the proposed Board regulation, an annotated legal ruling of counsel must include the following elements:

- “(1) a summary of pertinent facts,
- (2) an analysis of the issue(s),
- (3) references to any applicable statutes, regulations, or case law, and
- (4) a conclusion supported by the analysis.”

The proposed rule would also require the legal opinion to be “written and signed by the Chief Counsel or an attorney who is the Chief Counsel’s designee, addressing a specific tax application inquiry from a taxpayer or taxpayer representative, a local government, or board staff.”