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7 **BOARD OF EQUALIZATION**

8 **STATE OF CALIFORNIA**

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10 In the Matter of the Appeal of:) **HEARING SUMMARY**
11) **CORPORATION FRANCHISE TAX APPEAL**
12 **TAK DEVELOPMENT, INC.**¹) Case No. 765468
13)

Tax Year Ending	Claims for Refund ²
12/31/2005	\$ 16,429
12/31/2006	\$ 130
12/31/2007	\$ 1,026
12/31/2008	\$ 4,455
12/31/2009	\$ 26,831

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18 Representing the Parties:

19 For Appellant: Eric M. Anderson and Shail P. Shah
20 WTAS, LLC

21 For Franchise Tax Board: Jason Riley, Tax Counsel III
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23 QUESTION: Whether certain machines purchased by appellant are “qualified property,” within the
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25 ¹ Appellant owns and operates the Hotel Nikko in San Francisco County, California.

26 ² These amounts represent the current amounts at issue. The Notices of Action on Cancellation, Credit, or Refund for the tax
27 years at issue disallowed appellants’ claims for refund for a combined amount of \$72,019. (Resp. Op. Br., p. 4; App. Op. Br.,
28 Exh. A.) Appellant concedes \$23,147 of the \$72,019 in disallowed sales and use tax credits and asserts that it disputes the
disallowance of \$48,872 in sales and use tax credits. (App. Op. Br., p. 2.) The amounts listed above, as the claims for refund
in dispute, are amounts from page 3 of appellant’s opening brief. We note, however, that these amounts total \$48,871, not
\$48,872.

1 meaning of Revenue and Taxation Code (R&TC) section 23612.2, subdivision (b),
2 such that appellant is entitled to an additional amount of the enterprise zone sales and
3 use tax credit.
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5 HEARING SUMMARY

6 Background

7 Appellant owns and operates the Hotel Nikko located in San Francisco, California. The
8 hotel is located in a designated enterprise zone (EZ) according to the San Francisco Office of
9 Economic and Workforce Development. Appellant filed amended tax returns in October 2010 for the
10 tax years at issue, claiming the following refunds totaling \$244,838, based on the EZ sales and use
11 tax credits pursuant to R&TC section 23612.2: \$25,850 for the 2005 tax year; \$124,299 for the 2006
12 tax year; \$46,894 for the 2007 tax year; \$15,099 for the 2008 tax year; and \$32,696 for the 2009 tax
13 year. (Resp. Op. Br., p. 1; App. Op. Br., p. 1.)

14 Respondent performed an audit. During the audit, appellant's representative provided
15 respondent with schedules and supporting invoices regarding the equipment for the tax years at issue.
16 The schedules indicated the purchase date, vendor, project, description, amount, sales or use tax paid,
17 and verified if the sales or use tax paid on the equipment corresponded to the sales or use tax paid on the
18 invoices. Respondent determined that appellant paid the sales or use tax for various equipment used at
19 Hotel Nikko. Respondent's auditor identified each piece of machinery and determined whether it was
20 "qualified property" pursuant to R&TC section 23612.2, subdivision (b), and the auditor disqualified
21 any machinery that did not fall within the criteria of that statute. (Resp. Op. Br., pp. 1-2; App. Op. Br.,
22 pp. 180-203.)

23 As mentioned above, appellant owns and operates the Hotel Nikko. According to
24 respondent, on July 8, 2013, appellant's representative informed respondent that the assets of
25 Hotel Nikko are owned by DATAM SF, LLC (DATAM). Appellant's representative also explained in a
26 subsequent email that, while Hotel Nikko files its own California tax return, because the hotel's assets

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1 are owned by DATAM, Hotel Nikko cannot claim the EZ sales and use tax credit.³ Appellant's
2 representative further clarified by email the corporate ownership of appellant and TAK Hawaii to
3 DATAM and the ownership of the assets. Appellant indicated that DATAM is treated as a partnership
4 for California franchise tax purposes and files a Form 568 to report the LLC fee and distributive share of
5 income and loss to its members. Appellant indicated that it provided respondent with a schedule titled
6 "State Alternative Minimum Tax Depreciation Report" from the 2009 tax return of DATAM and other
7 schedules showing the invoices that reconcile to the depreciation report. Appellant indicated that these
8 schedules show that the assets purchased by DATAM for use at the hotel property are reported by
9 DATAM on its balance sheet. Appellant further explained that it held a 51 percent ownership in
10 DATAM and that TAK Hawaii held a 49 percent interest in DATAM. Appellant indicated that these
11 LLC members did not own any assets at the Hotel Nikko location in San Francisco. Appellant explained
12 that the credit at issue was generated at the LLC level and flowed through to appellant and TAK Hawaii.
13 Appellant explained that certain schedules were labeled TAK Development, Inc. because it is the
14 managing member of DATAM. Appellant also stated that it provided the Forms 100x and revised
15 Forms K-1 for each member of DATAM which reflect the credits allocable to each member. (Resp. Op.
16 Br., pp. 2-3; App. Op. Br., Exhs. B, C, D, E, F, G & H.)

17 Respondent's auditor reviewed the invoices and recalculated the qualified sales and use
18 tax paid on equipment used at Hotel Nikko. After reviewing appellant's available, utilized, and
19 carryover schedules, and invoices for the tax years at issue, respondent's auditor reduced appellant's
20 sales or use tax credit claimed for tax years at issue from \$241,658 to \$169,639 because respondent's
21 auditor determined that certain purchased property failed to be qualified property pursuant to R&TC
22 section 23612.2, subdivision (b). Respondent issued Notices of Action on Cancellation, Credit, or
23 Refund for each tax year on August 28, 2013. This timely appeal then followed. (Resp. Op. Br., pp.
24 3-4; App. Op. Br., Exh. A.)

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28 ³ A copy of this email is not included in the record.

1 Contentions

2 Appellant's Opening Brief

3 Appellant concedes the disallowance of \$23,147 of the \$72,019 in EZ sales and use tax
4 credit disallowed by respondent. Appellant notes that the remaining disputed property is comprised of:
5 (1) ice machines & stackers; (2) laundry machine/equipment; (3) laundry stacker & folder;
6 (4) evaporator; (5) trash compactor; (6) washsink aerator; (7) kitchen machine/equipment; (8) pizza
7 oven; (9) hot water heater; and (10) heating pump. For the remaining amount still in dispute (\$48,872),
8 appellant contends that the property in question is "qualified property" within the meaning original
9 R&TC section 23612.2, subdivisions (b)(2)(A)(i), (iii), and (iv). (App. Op. Br., pp. 2-3.)

10 *Laundry Equipment*

11 Appellant notes that respondent disallowed the claim for credit related to the purchase of
12 washers, extractors, laundry stackers, front loading washers, laundry pumps, and related machine parts.
13 Appellant contends that this property "is used to perform a series of mechanical operations on linens,
14 towels, and other materials to clean/sanitize and/or preserve their physical composition through a series
15 of mechanical and chemical processes." As such, appellant contends this property qualifies as
16 machinery and machinery parts used for "processing" under R&TC section 23612.2, subdivision
17 (b)(2)(A)(i). (App. Op. Br., p. 4.)

18 *Kitchen Equipment*

19 Appellant contends that clean agent fire suppression and building control products are
20 used "to preserve a commercial kitchen's optimal operational environment free of air contaminates."
21 Appellant contends that this property qualifies as machinery and machinery parts used for both air and
22 water pollution control mechanisms under R&TC section 23612.2, subdivision (b)(2)(A)(iii). (App. Op.
23 Br., p. 4.)

24 Appellant also contends that the trash compactors and related items were used to
25 "perform a series of mechanical operations on garbage and hotel waste to change its physical
26 composition/dimensions." Appellant contends that the evaporators and related items were used to
27 "perform a series of operations to absorb the heat in a space being refrigerated." As such, appellant
28 contends that this property qualifies as machinery and machinery parts used for "processing" under

1 R&TC section 23612.2, subdivision (b)(2)(A)(i). (App. Op. Br., p. 5.)

2 Appellant contends that the wash sink aerator is a water purifier which adds air to water
3 before the water comes out of a faucet, “changing the physical composition of the emerging water.”
4 Appellant contends that this property qualifies as machinery or machinery parts used for “processing”
5 under R&TC section 23612.2, subdivision (b)(2)(A)(i). In the alternative, appellant contends that this
6 property qualifies as machinery and machinery parts used for water pollution control pursuant to R&TC
7 section 23612.2, subdivision (b)(2)(A)(iii)(II). (App. Op. Br., p. 5.)

8 Appellant contends that the freezers are used “to perform a series of mechanical
9 operations to change water into ice, as well as to preserve the condition of food.” Appellant also
10 contends that the pizza ovens, convention ovens, and range gas fryers were used to “perform a series of
11 chemical operations to change the properties of food.” As such, appellant contends that this property
12 qualifies as machinery and machinery parts used for processing water and food pursuant to R&TC
13 section 23612.2, subdivision (b)(2)(A)(i). (App. Op. Br., p. 5.)

14 *Ice Machines*

15 Appellant contends that the ice machines were used to “perform a series of mechanical
16 operations to alter the physical properties of water, transforming it into ice.” As such, this property
17 qualifies as machinery and machinery parts used for processing water pursuant to R&TC section
18 23612.2, subdivision (b)(2)(A)(i). (App. Op. Br., p. 5.)

19 *Heating Pumps*

20 Appellant contends that the hot water heaters/heating pumps “are necessary to maintain
21 constant water temperatures, and to monitor and control the quality of water used at the hotel premises.”
22 Appellant further contends that the timely maintenance and replacement of water heaters and their
23 component parts prevents the consumption of polluted water, reduces the consumption of water
24 contaminated by rust, and helps monitor the overall quality of the water being used to bathe, clean, or
25 drink. Appellant contends that this property qualifies as machinery and machinery parts used for water
26 pollution pursuant to R&TC section 23612.2, subdivision (b)(2)(A)(iii)(II). Appellant further contends
27 that this property qualifies as machinery and machinery parts used for processing water pursuant to
28 R&TC section 23612.2, subdivision (b)(2)(A)(i), because a working water heater “is used to perform a

1 series of mechanical and chemical operations on cold water to change its physical and chemical
2 composition by warming the water.” (App. Op. Br., pp. 5-6.)

3 Respondent’s Opening Brief

4 Respondent notes that the amount at issue represents 19.96 percent of the claimed sales
5 and use tax credit claimed by appellant. Respondent contends that appellant is not entitled to this
6 remaining claimed credit because the specific machinery purchased by appellant does not meet the
7 definition of “qualified property” pursuant to R&TC section 23612.2, subdivision (b). (Resp. Op. Br.,
8 p. 4.)

9 Respondent notes that “qualified property” includes many types of tangible property and,
10 for purposes of this appeal, qualified property is “machinery and machinery parts used for fabricating,
11 processing, assembling and manufacturing,” citing R&TC section 23612.2, subdivision (b)(2)(i).
12 Respondent acknowledges that “processing” is not defined in the statute. Respondent contends that, in
13 construing statutes, the legislative intent must be determined and applied, citing *Lennane v.*
14 *Franchise Tax Board* (1994) 9 Cal.4th 263. Respondent contends that the first step is to examine the
15 words of the statute and to give those words their usual and ordinary meaning. Respondent contends
16 that, if there is no ambiguity in the language in the statute, then the Legislature is presumed to have
17 meant what it said and the plain meaning of the language governs. Respondent further contends that,
18 when a word used in a statute has a well-established legal meaning, it will be given that meaning in
19 construing the statute, citing *Arnett v. Dal Cielo* (1996) 14 Cal.4th 4, 19. Respondent contends that a
20 specific provision in a statute should be construed with reference to the entire statutory system of which
21 it is a part, in such a way that the various elements of the overall scheme are harmonized, citing
22 *Bowland v. Municipal Court* (1976) 18 Cal.3d 479, 489. (Resp. Op. Br., pp. 5-6.)

23 Respondent contends that the word “processing” is defined by Webster’s Third
24 New International Dictionary (1966) as “to subject to a particular method, system, or technique of
25 preparation, handling, or other treatment designed to effect a particular result and to put through a
26 special process as to prepare for market manufacture or other commercial use by subject to some
27 process.” Respondent contends that the issue in this appeal is whether R&TC section 23612.2 restricts
28 the definition of “processing” to the processing of a product manufactured or processed for sale to its

1 customers or whether “processing” applies to any purpose, and whether appellant engaged in an activity
2 that could be considered “processing.” Respondent contends that the phrase “[m]achinery and
3 machinery parts used for fabricating, processing, assembling and manufacturing” is used within the
4 statute as an exclusive list. Respondent contends that appellant’s interpretation of “processing” would
5 effectively mean that there is no restriction in the statute on how any machinery and parts should or
6 could be used to qualify for the credit. Respondent argues that following appellant’s overly broad and
7 incorrect interpretation renders this intended and restrictive use portion of the statute moot. (Resp. Op.
8 Br., p. 6.)

9 Respondent argues that, only by following respondent’s determination, can the Board
10 ensure that “processing” is interpreted in its commercial sense of preparing goods for sales, under the
11 context and as limited in R&TC section 23612.2, subdivision (b)(A)(ii), in administering the statute.
12 Respondent asserts that it is inherent within the statute that the product to be manufactured or processed
13 is for the purpose of sale to customers, rather than for any purpose. Respondent contends that it has a
14 long history of published guidance with respect to the definition of “qualified property”, and the terms
15 “manufacturing” and “processing”, and in each instance these terms have been used to describe
16 operations that prepare goods for sale. Respondent contends that, while respondent traditionally gave
17 the term “processing” a broad meaning, it has always interpreted the statute as requiring that the term
18 “processing” describe operations that prepare goods for sale. In support, respondent cites a

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1 Technical Advice Memorandum (TAM) and several Chief Counsel Rulings.⁴ Respondent contends that
2 the equipment appellant purchased was not used in “processing” goods for sale within the context of
3 R&TC section 23612.2, subdivision (b)(2)(A)(i). (Resp. Op. Br., p. 7, Exh. A.)

4 As for the laundry equipment, respondent contends that appellant used laundry equipment
5 to launder linens and towels which is an ancillary activity to appellant’s hotel operation. Respondent
6 contends that appellant does not sell the linens or towels that it washes in the laundry equipment.

7 Respondent contends that the linens and towels are used internally, are not transported to the
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9 ⁴ In TAM-89-0113 (Feb. 27, 1989), respondent opined that whether equipment was used for “manufacturing” is determined
10 by whether the taxpayer was processing raw materials into the taxpayer’s final product and whether the equipment in
11 question was used directly in that activity. Respondent opined that machinery parts used for rebuilding existing machinery
12 probably would not qualify because the taxpayer was not actually manufacturing a new product for sale to customers, but was
13 performing a service of repairing a product for its owner. Respondent also opined that, on the other hand, if the taxpayer
14 bought old machinery, disassembles it and adds new parts, then sells the machinery to new customers, it would probably
15 qualify because the taxpayer would be creating a new product for sale. (Resp. Op. Br., Exh. A, pp. 1-3.)

16 In AR-97-0284 (Aug. 22, 1997), respondent opined that whether equipment was used for “processing” depends on whether
17 the equipment was used to prepare goods for sale or used in the operations of the business that sells the goods. Respondent
18 indicated that property used in the selling operations would not qualify for the credit, while property used to prepare the
19 product for sale would qualify. Respondent indicated that the equipment used in a distribution center would be “qualified
20 property” because the operation is part of a cohesive processing operation that processes goods into complete store orders in
21 preparation of an eventual retail sale. (Resp. Op. Br., Exh. A, pp. 4-5.)

22 In CR-88-297 (Aug. 5, 1988), respondent opined that the equipment used to float, rinse, dry, wax, and sort apples in
23 preparation for final packaging is machinery used in “processing” the apples and “qualified property.” Respondent opined
24 that, on the other hand, the cold storage equipment facilities used for storage of the finished product is not “qualified
25 property.” (Resp. Op. Br., Exh. A, pp. 6-7.)

26 In CR-88-368 (Sept. 22, 1988), respondent opined that a taxpayer engaged in the service of collecting documents and
27 manufacturing the final documents to be used at trial used its new copy machines and new computer equipment in
28 fabricating, processing, assembling and manufacturing of the taxpayer’s final product (subpoenas and material suitable for
trial use). As such, respondent opined that the equipment was “qualified property.” (Resp. Op. Br., Exh. A, pp. 8-10.)

In CR-90-064 (Feb. 6, 1990), respondent opined that a taxpayer’s equipment used in the taxpayer’s automated process to
receive freight, remove freight from its original packaging, sort the goods, repack and load the goods onto trucks bound for
retail stores was used in “processing” and therefore, the equipment was “qualified property.” Respondent opined that the
equipment is part of a cohesive processing facility which processes raw goods into complete, batched store orders in
preparation for eventual sale. (Resp. Op. Br., Exh. A, pp. 11-12.)

In CR-92-437 (July 16, 1992), respondent opined that a taxpayer’s automobile shredder which was purchased prior to the
time the taxpayer was engaged in a trade or business within an area designated as an EZ was not qualified property for the
credit. Respondent further opined that sales or use tax paid after the designated date in connection with that property for
installation expenses and other incidental parts would qualify for the credit. (Resp. Op. Br., Exh. A, pp. 13-15.)

In CI-90-402 (Sept. 7, 1990), respondent opined that where a corporate taxpayer with four subsidiaries and the second and
third subsidiaries are subcontracted to manufacture the product of the first subsidiary, the first subsidiary may claim the credit
for eligible equipment purchases. The first subsidiary provided the equipment and a portion of labor to the second and third
subsidiaries used in the manufacturing site. (Resp. Op. Br., Exh. A, pp. 16-17.)

1 marketplace, and are not goods prepared for sale. Respondent contends that the towel remains a towel
2 after being cleaned and a washing machine's transitory retention of that towel, followed by its return to
3 the hotel room, illustrates "the overly broad and unsound application" of the credit as appellant suggests.
4 Respondent contends that laundry machines are not "qualified property" within the meaning of R&TC
5 section 23612.2. (Resp. Op. Br., p. 7.)

6 As to the ice machines and hot water heaters, respondent contends that appellant's use of
7 the ice machines to create ice from the municipal water supply is an ancillary activity to appellant's
8 hotel operation. Respondent contends that, similarly, appellant's use of the hot water heaters to heat
9 water is an ancillary activity to appellant's hotel operations. Respondent contends that appellant does
10 not sell ice made by the ice machine or hot water heated by the hot water heaters. Respondent contends
11 that the ice and the hot water are used internally, are not transported to the marketplace, and are not
12 goods prepared for sale. Respondent further contends that kitchen equipment, such as trash compactors,
13 evaporators, clean air fire suppression, and aerators are all ancillary to appellant's hotel operations.
14 Respondent contends that appellant does not sell compacted trash or absorbed heat as these are waste
15 products that are not transported to the market place, and are not goods for sale. As such, respondent
16 contends that appellant's machinery does not meet the meaning of "processing" and it is not "qualified
17 property" under R&TC section 23612.2, subdivision (b)(2)(A)(i). (Resp. Op. Br., p. 8.)

18 Respondent contends that, if the Board adopts appellant's interpretation of "processing",
19 it would render the statute meaningless and should be rejected. Respondent contends that it long
20 considered that preparing goods for sale is inherent in the definition of the term "processing."
21 Respondent contends legislative history of the statute shows that the credit was intended to aid classical
22 manufacturers located in depressed areas of the state by allowing these manufacturers a credit against
23 net tax for the sales or use tax incurred by the taxpayer exclusively within an EZ. Respondent argues
24 that the credit was meant for manufacturers and, if the Legislature intended the statute to apply to
25 services, the Legislature could have written that into the statute. Respondent contends that the statute, as
26 enacted, intended the product of the manufacturing and processing to be prepared for sale and to foster
27 manufacturing within an EZ. Respondent contends that appellant's interpretation would allow a
28 taxpayer to purchase a machine for any purpose, related or unrelated to the preparation of goods for sale,

1 would render the statute meaningless, and will result in unmerited claims in this appeal as well as
2 encourage even more outlandish credit claims from all remaining taxpayers in the EZ. Respondent
3 contends that an overly broad interpretation, such as appellant's, results in a transfer of money from all
4 taxpayers to those taxpayers who happen to be located in an EZ such that they can claim the EZ sales
5 and use tax credit for any activity whether or not that activity was one that the Legislature intended to
6 encourage. Respondent further contends that the policy behind allowing a sales tax credit on machinery
7 that produced products for sale is that the state will collect sales tax from those goods and products
8 prepared for sale at the time of their sale. Respondent contends that, where the object or product of the
9 manufacturing or processing is not for sale, the consequences of allowing a credit under such
10 circumstances deprives the state of a means to recover any value in the cost of the credit. Respondent
11 contends that the consequence of appellant's interpretation would be that the state loses out twice: once
12 for any credit allowed for activities not intended to be creditable by the statute and again from the lack
13 of sales tax revenue collected because there were no goods produced for sale. Respondent requests that
14 its action be sustained. (Resp. Op. Br., pp. 8-10, Exh. B.)

15 Appellant's Reply Brief

16 Appellant contends that, contrary to respondent's position, R&TC section 23612.2 does
17 not require that "qualified property" be used only to "process" or "manufacture" goods for sale to
18 customers. Appellant contends that all taxpayers conducting a trade or business within an EZ are
19 qualified for the sales tax credit, citing R&TC section 23612.2, subdivision (b)(1). Appellant notes that
20 it was allowed to claim the credit for data processing and communications equipment under R&TC
21 section 23612.2, subdivision (b)(2)(A)(iv), despite appellant not being in the data processing or
22 communications business. Appellant contends that R&TC section 23612.2, subdivision (b)(2)(A)(i),
23 only requires the machinery and machinery parts be used for fabricating, processing, assembling, and
24 manufacturing to be "qualified property." Appellant argues that there is no requirement that a taxpayer
25 must be a manufacturer or processor. Appellant contends that respondent incorrectly relies on TAM
26 89-0113 as TAM 89-0113 merely states that the "[m]achinery parts used for rebuilding existing
27 machinery *probably* would not qualify because the taxpayer is not actually manufacturing a new product
28 for sale to customer . . ." Appellant further contends that respondent's position that the FTB's long

1 history of guidance interpreting the definition of “qualified property” as solely property used to
2 manufacture or process goods for sale is misleading. Appellant contends that the FTB cites to
3 Chief Counsel Rulings interpreting the applicable statute to a specific set of facts where the taxpayers
4 are selling goods to consumers. Appellant argues that the fact that a taxpayer is selling goods to
5 consumers is not dispositive to the issue of whether qualified property must be used in the
6 manufacturing or processing of goods sold to third parties. Appellant contends that the applicable
7 statute does not require this condition. (App. Reply Br., pp. 1-2.)

8 Appellant contends that, even if this was a condition required by the statute, appellant has
9 satisfied this condition. Appellant asserts that the laundry equipment was used to process towels and
10 linens that are provided to hotel guests and the cost of processing the towels and linens is passed on to
11 the customer in the room rate. Appellant contends that a hotel which did not provide towels and linens
12 would likely charge its guests a lower room rate. As for respondent’s argument that the use of the
13 laundry equipment is ancillary to appellant’s hotel operation, appellant contends that there is no
14 requirement in the statute which restricts the credit to only taxpayers engaged in a manufacturing or
15 processing business, citing the Board’s decision in the *Appeal of Save Mart Supermarkets (Save Mart)*,
16 2002-SBE-002, decided on February 6, 2002.⁵ Appellant contends that it also provides laundry services
17 to its guests for a separate charge and uses the laundry equipment in an activity that is directly charged
18 to customers. Appellant argues that there is no restriction in the statute which allows a stand-alone
19 laundromat, situated next door to appellant, a credit for equipment that is exactly the same, and used in
20 exactly the same way, as the equipment used by appellant. Appellant argues that, had the Legislature
21 contemplated such a restriction, it could have included a taxpayer industry requirement as it did with
22 regards to the manufacturing investment credit pursuant to R&TC section 23649 and the partial
23 manufacturing equipment sales tax exemption pursuant to R&TC section 6377.1, subdivision (b)(6)(A).

25 ⁵ In the *Save Mart* appeal, the Board determined that respondent’s interpretation of “qualified taxpayer” for purposes of the
26 Manufacturing Investment Credit (MIC) under R&TC section 23649 as set forth in Regulation 23649-3 enlarged the words of
27 the statute and, therefore, Regulation 23649-3 was invalid. Noting that the MIC should be interpreted liberally in favor of
28 taxpayers, the Board determined that the taxpayer, a grocery store chain with an in-house bakery and meat department in its
stores, was a “qualified taxpayer” eligible for the credit because the taxpayer engaged in the manufacturing activities of meat
processing and baking. The Board noted that the language in the statute did not require a taxpayer to be primarily engaged in
the business of baking or meat processing. The Board further noted that the taxpayer’s manufacturing activities constituted
more than a trifling or irrelevant segment of its overall operations.

1 Appellant contends that, similarly, the ice machines were used to make ice for its guests and the cost of
2 the ice was passed on to the guests through the room rate and additional charges for beverages in the
3 restaurant or room service. Appellant further contends that the kitchen equipment is used to provide
4 food products which are sold to third party customers. Appellant contends that it used the kitchen
5 equipment to process raw food into meals sold to its hotel guests and that this activity falls within
6 respondent's definition of processing. (App. Reply Br., pp. 3-4.)

7 As for respondent's contention that the state would lose out twice by allowing the credit
8 and not collecting sales tax, appellant argues that this is disingenuous. Appellant contends that hotels,
9 such as appellant, charge sales and use tax to hotel guests for room stays and prepared meals. Appellant
10 contends that, to argue that the state does not collect sales and use taxes based on a percentage of the
11 room rate which embeds charges for laundry, ice, and hot water, is simply not true and for prepared food
12 is false. Appellant further contends that there is no requirement that the ultimate sale be subject to sales
13 tax as a condition for the EZ sales or use tax credit. (App. Reply Br., p. 4.)

14 Respondent's Reply Brief

15 As for appellant's contention that there is no requirement that a taxpayer must be a
16 manufacturer or processor to claim the credit, respondent contends that R&TC section 23612.2,
17 subdivision (b)(2)(A)(i), requires a taxpayer to use machinery in "fabricating, processing, assembling,
18 and manufacturing." Respondent contends that the Board should give the words in the statute its
19 ordinary meaning and, if the statutory language is clear and unambiguous, then the Board does not need
20 to go any further, citing *Wilcox v. Birtwhistle* (1999) 21 Cal.4th 973, 977, and *Lungren v. Deukmejian*
21 (1988) 45 Cal.3d 727, 735. Respondent further contends that the term "and" is ordinarily conjunctive
22 and nothing suggests a legislative intent to give the term "and" a different meaning, citing
23 *Hoechst Celanese Corp. v. Franchise Tax Board* (2001) 25 Cal.4th 508. Respondent notes that the
24 words "fabricating", "processing", "assembling", and "manufacturing" are defined by the Webster's
25 Third New International Dictionary (1966) as follows:

- 26 • Fabricating: To form by art or labor - manufacture, produce; to form into a whole by uniting
27 parts - construct, build; often used to describe building up into a whole by uniting
28 interchangeable standardized parts.

- 1 • Processing: To subject to a particular method, system, or technique of preparation, handling, or
2 other treatment designed to effect a particular result; put through a special process, as to prepare
3 for market manufacture or other commercial use by subjecting to some process.
- 4 • Assembling: To bring together as to put or join together usually in an orderly way with logical
5 selection or sequence; to fit together various parts as to make into an operative whole.
- 6 • Manufacturing: To make (as raw material) into a product suitable for use; to make from raw
7 materials by hand or machinery.

8 Respondent argues that, in the context of R&TC section 23612.2, subdivision
9 (b)(2)(A)(i), the ordinary meanings of these terms do not apply to inn keeping services. Respondent
10 contends that the machinery purchased by appellant was not used for “fabricating, processing,
11 assembling, and manufacturing” ice or linens. Respondent maintains that providing ice and clean linens
12 to hotel guests, while part of a service provided by an innkeeper, does not involve “fabricating,
13 processing, assembling, and manufacturing.” Respondent maintains that appellant is simply returning
14 the same item that entered the machinery in the same form: water, linen and towels. Respondent
15 maintains that appellant’s interpretation of the statute would render it meaningless and would allow any
16 device to qualify for the credit. Respondent contends that the Legislature did not intend to allow the
17 credit for any activity under the sun. (Resp. Reply Br., pp. 1-4.)

18 As for appellant’s contention regarding standalone laundry being entitled to the credit,
19 respondent asserts that, unless the standalone laundry is fabricating, assembling, processing, and
20 manufacturing, respondent disagrees that appellant would be entitled to the credit. Respondent contends
21 that a standalone laundry employing the same type of laundry machines purchased by appellant does not
22 fabricate, process, assemble, and manufacture linens, towels, or blue jeans. Respondent further contends
23 that, in the standalone laundry, the customers themselves are the actors in depositing their clothes in the
24 machines and getting the same clothes returned to them. Respondent contends that such customers are
25 not fabricating, assembling, processing, and manufacturing, and they are not doing so on behalf of the
26 machinery’s owner. (Resp. Reply Br., p. 4.)

27 As to appellant’s contention that they were allowed the credit for certain data processing
28 and communications equipment under R&TC section 23612.2, subdivision (b)(2)(A)(iv), respondent

1 points out that the statute does not have the same requirement to fabricate, process, assemble, and
2 manufacture. Respondent contends that there is no requirement for any additional action beyond the
3 purchase of data processing and communications equipment for use exclusively within a designated EZ
4 in R&TC section 23612.2, subdivision (b)(2)(A)(iv). Respondent contends that appellant's comparison
5 is not relevant and confuses a provision related to a type of property with a different provision that
6 additionally requires and looks to a qualifying use of that property. As such, respondent contends that
7 its determination should be upheld. (Resp. Reply Br., p. 5.)

8 Applicable Law

9 Burden of Proof

10 Tax credits are a matter of legislative grace and a taxpayer has the burden of showing an
11 entitlement to the claimed tax credits. (*INDPOCO, Inc. v. Commissioner* (1992) 503 U.S. 79, 84;
12 *New Colonial Ice Co. v. Helvering* (1934) 292 U.S. 435, 440; *Appeal of Robert R. Telles*, 86-SBE-061,
13 Mar. 2, 1986; *Appeal of James C. and Monablance A. Walshe*, 75-SBE-073, Oct. 20, 1975.) Statutes
14 granting tax credits are to be construed strictly against the taxpayer with any doubts resolved in
15 respondent's favor. (*Dicon Fiberoptics, Inc. v. Franchise Tax Board* (2012) 53 Cal.4th 1227, 1236. See
16 also *Tax & Accounting Software Corp. v. United States* (10th Cir. 2002), 301 F.3d 1254, 1261;
17 *Medchem Inc. v. Commissioner* (1st Cir. 2002) 295 F.3d 118, 123.)

18 Furthermore, it is well-settled that a presumption of correctness attends respondent's
19 determinations as to issues of fact and a taxpayer has the burden of proving error in such determinations.
20 (*Appeal of Oscar D. and Agatha E. Seltzer*, 80-SBE-154, Nov. 18, 1980.) This presumption is a
21 rebuttable one and will support a finding only in the absence of sufficient evidence to the contrary. (*Id.*)
22 A taxpayer's unsupported assertions are not sufficient to satisfy his burden of proof. (*Appeal of*
23 *James C. and Monablance A. Walshe, supra.*)

24 Enterprise Zone Sales and Use Tax Credit

25 R&TC section 23612.2 allows a credit in an amount equal to the sales or use tax paid or
26 incurred in connection with a taxpayer's purchase of qualified property. "Taxpayer" means a
27 corporation engaged in a trade or business within an enterprise zone. (Rev. & Tax. Code, § 23612.2,
28 subd. (b)(1).) "Qualified property" includes many types of tangible property, such as the following:

1 machinery and machinery parts used for fabricating, processing, assembling, and manufacturing (*Id.*,
2 subd. (b)(2)(A)(i)); machine and machinery parts used for either air pollution control mechanisms or
3 water pollution control mechanisms (*Id.*, subd. (b)(2)(A)(iii)); data processing and communications
4 equipment including, but not limited to, computers, computer-automated drafting systems, copy
5 machines, telephone systems, and faxes (*Id.*, subd. (b)(2)(A)(iv)); and motion picture manufacturing
6 equipment central to production and postproduction, including, but not limited to, cameras, audio
7 recorders, and digital image and sound processing equipment (*Id.*, subd. (b)(2)(A)(v)).

8 The total cost of the qualified property that is “purchased and placed in service” in any
9 one year that may be taken into account for purposes of claiming the credit cannot exceed \$20,000,000.
10 (*Id.*, subd. (b)(2)(B).) The qualified property must be used by the taxpayer exclusively in an enterprise
11 zone. (*Id.*, subd. (b)(2)(C).) Further, the qualified property must be “purchased and placed in service”
12 while the enterprise zone is operative. (*Id.*, subd. (b)(2)(D).)

13 The objective of statutory interpretation is to ascertain and effectuate legislative intent by
14 giving meaning to every word and phrase in the statute to accomplish a result consistent with the
15 legislative purpose. (*Plaza Hollister Ltd. Partnership v. County of San Benito* (1999) 72 Cal.App.4th 1,
16 35.) Secondly, statutes are given effect according to the usual, ordinary import of the language used in
17 framing them, and where the statutory language is clear and unambiguous, there is no need for
18 construction. (*People v. Belleci* (1979) 24 Cal.3d 879, 884; *Solberg v. Superior Court* (1977)
19 19 Cal.3d 182, 198.) If, however, the language supports more than one reasonable interpretation, we
20 look to a variety of extrinsic aids, including the objects to be achieved, the evils to be remedied,
21 legislative history, the statutory scheme of which the statute is a part, contemporaneous administrative
22 construction, and questions of public policy. (*In re Derrick B.* (2006) 39 Cal.4th 535, 539.) Where
23 uncertainty exists, consideration should be given to the consequences that will flow from a particular
24 interpretation. (*Dyna-Med, Inc. v. Fair Employment & Housing Com.* (1987) 43 Cal.3d 1379, 1387.)
25 The interpretation accorded a statute by the agency charged with administering the statute is to be given
26 great weight and the Board is reluctant to substitute its own judgment unless it is persuaded that
27 respondent's construction is clearly erroneous. (*Appeal of Russell B. Jr., and Margaret A. Pace*,
28 92-SBE-013, May 7, 1992.)

1 STAFF COMMENTS

2 Qualified taxpayers in a designated EZ are entitled to a tax credit for the sales and use tax
3 paid on the purchase of “qualified property” used within the designated EZ. (Rev. & Tax. Code,
4 § 23612.2.) It appears that the parties agree appellant operates a hotel in San Francisco, a designated
5 EZ. The parties dispute whether the following equipment appellant purchased is “qualified property”
6 for purposes of the EZ sales and use tax credit: (1) ice machines and stackers; (2) laundry
7 machine/equipment; (3) laundry stacker and folder; (4) evaporator; (5) trash compactor; (6) washsink
8 aerator; (7) kitchen machine/equipment; (8) pizza oven; (9) hot water heater; and (10) heating pump.

9 As relevant to this appeal, “qualified property” includes “machinery and machinery parts
10 used for fabricating, processing, assembling, and manufacturing” (*Id.*, subd. (b)(2)(A)(i)). It appears
11 that the term “processing” is not defined in the statute. Respondent contends that there is no ambiguity
12 in the statute and that R&TC section 23612.2 restricts the definition of “processing” to the processing of
13 a product manufactured or processed for sale to its customers. Appellant contends that the statute does
14 not require that a taxpayer use the equipment in the processing of goods sold to third parties. The parties
15 will want to discuss, and provide supporting authority for, whether “processing” requires the machinery
16 to be used in the processing of a good or product for sale to be “qualified property” pursuant to R&TC
17 section 23612.2, subdivision(b)(2)(A)(i).

18 The parties will also want to discuss, and provide evidence of, the legislative history
19 supporting their interpretations. Staff notes that respondent provided a memorandum addressed to
20 Stan DiOro of Assemblywoman Maxine Waters’s Office from the FTB dated August 12, 1985, which
21 describes the tax benefits available to businesses in an EZ, such as the EZ sales and use tax credit. Staff
22 notes that the example of the applicability of the EZ sales and use tax credit describes a business located
23 in an EZ setting up a “new production line for its operation.” The parties should be prepared to discuss
24 the significance, if any, of this memorandum. (Resp. Op. Br., Exh. B, p. 13.)

25 Staff further notes that the TAM and Chief Counsel Rulings submitted by respondent
26 contemplate scenarios where the taxpayer produced a good or product for sale. In addition, in
27 Chief Counsel Ruling AR-97-0284 (Aug. 22, 1997), respondent differentiated equipment used in
28 preparing a good to be sold versus equipment used in a taxpayer’s operation of the business. (Resp. Op.

1 Br., Exh. A.) The parties should be prepared to discuss whether respondent’s interpretation of
2 “processing” for purposes of determining whether equipment is qualified property is clearly erroneous in
3 light of the statute listing the term “processing” within the list of “fabricating, processing, assembling,
4 and manufacturing.” (See *Appeal of Russell B. Jr., and Margaret A. Pace, supra.*)

5 It appears to staff that appellant purchased the laundry equipment and ice machines to
6 clean towels and linens and to make ice for its hotel customers as part of appellant’s hotel operations. If
7 the Board determines that “processing” requires that the equipment is used to process a good for sale, it
8 appears that the laundry equipment would not satisfy the definition of qualified property pursuant to
9 R&TC section 23612.2, subdivision (b)(2)(A)(i), because the laundry equipment is used to process
10 towels and linens which are not sold by appellant and appears to be a part of appellant’s hotel operations
11 of providing clean towels and linens in its hotel. Similarly, it appears that the ice machine was used to
12 make ice to be used in appellant’s hotel operations. Appellant contends that it used the kitchen
13 equipment to process raw food into prepared meals, which appellant then sold to its hotel guests. The
14 parties should discuss whether the kitchen equipment is “qualified property” under respondent’s
15 interpretation of R&TC section 23612.2, subdivision (b)(2)(A)(i).

16 Staff notes that appellant asserts that the wash sink aerator is a water purifier that
17 qualifies as machinery and machinery parts used for water pollution pursuant to R&TC section 23612.2,
18 subdivision (b)(2)(A)(iii)(II). Appellant asserts that the heating pumps and hot water heaters monitor
19 and control the quality of water used at the hotel premises which qualify as machinery and machinery
20 parts used for water pollution pursuant to R&TC section 23612.2, subdivision (b)(2)(A)(iii)(II).
21 Appellant claims that the clean agent fire suppression and building control products are used “to
22 preserve a commercial kitchen’s optimal operational environment free of air contaminates” and this
23 property qualifies as machinery and machinery parts used for both air and water pollution control
24 mechanisms under R&TC section 23612.2, subdivision (b)(2)(A)(iii). It appears to staff that respondent
25 did not specifically address appellant’s contentions regarding the above equipment qualifying as
26 machinery and machinery parts used for air and water pollution control. The parties will want to
27 discuss, and provide supporting authority for their positions on, whether this equipment is used for air
28 and water pollution control such that this equipment is “qualified property” pursuant to R&TC section

1 23612.2, subdivision (b)(2)(A)(iii).

2 If either party has any additional evidence to present, they should provide their evidence
3 to the Board Proceedings Division at least 14 days prior to the oral hearing pursuant to California Code
4 of Regulations, title 18, section 5523.6.⁶

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⁶ Evidence exhibits should be sent to: Khaaliq Abd'Allah, Appeals Analyst, Board Proceedings Division, State Board of Equalization, P.O. Box 942879 MIC:80, Sacramento, California, 94279-0080.