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7 **BOARD OF EQUALIZATION**

8 **STATE OF CALIFORNIA**

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10 In the Matter of the Appeal of:) **REHEARING SUMMARY**
11) **CORPORATION FRANCHISE TAX APPEAL**
12 **TAIHEIYO CEMENT USA, INC.**) Case No. 332855
13)

| | <u>Year Ended</u> | <u>Claim For Refund¹</u> |
|--|-------------------|-----------------------------------------|
| | December 31, 1998 | \$ 72,173.00 |

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16 Representing the Parties:

17 For Appellant: Steve West, Deloitte Tax LLP

18 For Franchise Tax Board: Ann H. Hodges, Tax Counsel III
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20 QUESTION: Whether “qualified property” within the meaning of Revenue and Taxation Code section
21 23612.2 includes both capitalized and expensed property.
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23 HEARING SUMMARY

24 Background

25 On February 4, 2008, this Board issued a letter decision informing appellant that on
26 February 1, 2008, the Board considered the above-entitled appeal and voted to sustain the action of
27 respondent Franchise Tax Board (respondent or FTB) disallowing appellant’s claim for Enterprise Zone
28

¹ Respondent should be prepared to present an interest calculation at the hearing.

1 credit for sales tax paid on currently expensed property for the year on appeal.

2 Appellant filed a timely petition for rehearing in which appellant asserts that this Board
3 made the following errors of law:

- 4 • The plain language of Revenue and Taxation Code (R&TC) section 23612 prior to the re-
5 adoption of the Enterprise Zone Credit for sales and use tax (Credit) in R&TC section 23612.2
6 does not limit application of the Credit to capital assets. Because the re-adoption of the Credit in
7 section 23612.2 was not effective until January 1, 1997, appellant is entitled to Credit on
8 expensed replacement parts at issue in this appeal for the years prior to 1997.
- 9 • The Hearing Summary erroneously stated that the reference to Internal Revenue Code (IRC)
10 section 164(a) in R&TC section 23612, subdivision (e), applies only to capital assets. IRC
11 section 164(a) applies to both capital and expensed assets, thus, the term “basis” as used in
12 R&TC section 23612, subdivision (e), also applies to both capital and expensed assets. In view
13 of that interpretation, the Board erred by not granting the claim for refund of the amount of the
14 credits accumulated prior to 1997.
- 15 • If the standard for interpreting the phrase “placed in service” as not applicable to capital assets,
16 was also applied to the term “basis” as used in R&TC section 23612, subdivision (e), the Board
17 would have concluded that “basis” applied to both capital and expensed assets.
- 18 • By voting to sustain respondent’s action, the Board held that the term “placed in service” limits
19 the Credit to sales tax paid on capital assets. For that reason, the amendment to R&TC section
20 23612.2 made by Senate Bill 2023 is not clarifying language but rather must be considered the
21 addition of the requirement that “qualified property” be capitalized.

22 Question: Whether “qualified property” within the meaning of R&TC section 23612.2 includes both
23 capitalized and expensed property.

24 Contentions

25 Appellant’s Contentions

26 Because the plain language definition set forth in R&TC section 23612.2 does not limit
27 “qualified property” to capitalized property, appellant contends that statutory construction of that term is
28 not necessary. Thus, appellant concludes that it is entitled to the Credit for machinery parts because the

1 plain language definition does not indicate that machinery parts are not included with the meaning of
2 “qualified property.” (App. Op. Br., p. 2.)

3 In addition, appellant notes that the R&TC contains a number of credit statutes similar to
4 section 23612.2 which expressly limit “qualified property” to depreciated property. Appellant asserts
5 that respondent has not “sufficiently addressed” why the Legislature would set an express limitation in
6 other statutes but not under section 23612.2. Appellant contends that the absence of such a limitation in
7 R&TC section 23612.2 demonstrates that the Legislature did not intend the Credit to be limited to
8 depreciated property. (App. Op. Br., pp. 2-3.)

9 Appellant also contends that because IRC section 164(a) and the term “basis” are not
10 limited to depreciated property, such a limitation may not be read in to subdivision (e) of R&TC section
11 23612.2. In this regard, appellant disputes respondent’s position that the Legislature intended the term
12 “basis” as used in subdivision (e) to have a different meaning than the term “cost” as used in IRC
13 section 164(a) and respondent’s conclusion that basis refers specifically only to depreciated property.
14 Appellant contends that the Legislature intended “basis” and “cost” to have the same meaning because
15 the provision of subdivision (e) proscribing an increase in basis as a result of electing the Credit
16 incorporates by reference the provision of IRC 164(a) which requires a taxpayer to increase the cost of
17 acquisition. (App. Op. Br., pp. 4-5.)

18 Appellant further contends that the term “placed in service” under R&TC sections
19 23612.2, subdivisions (b)(2)(B) and (b)(2)(D) does not support respondent’s position that “qualified
20 property” means only depreciated property. Appellant asserts that respondent takes an unnecessarily
21 narrow interpretation of “placed in service” to construe the term “qualified property”. Appellant states
22 that “placed in service” means the date on which property is “in a condition or state of readiness or
23 availability” which applies to all types of assets, and is not narrowly limited to the starting date for the
24 depreciation of a capitalized asset. Appellant also contends that the “well-established” application of the
25 term “placed in service” to expensed spare parts for machinery and equipment and the inclusion of parts
26 as an example of “qualified property” leads one to the logical conclusion that the Legislature intended
27 “placed in service” to apply to both expensed and capitalized parts under section 23612.2. (App. Op. Br.,
28 p. 6.)

1 Appellant contends that respondent has not been consistent or uniform in applying its
2 interpretation of R&TC section 23612.2. As evidence of its contention, appellant states that
3 respondent's auditor and the auditor's supervisor were unaware of this interpretation as shown by the
4 fact that they did not disallow the Credit for expensed assets in the original audit. Appellant also asserts
5 that it discovered another taxpayer for whom the Credit was allowed for expensed assets. Appellant
6 provides a copy of the Audit Issue Presentation Sheet for the other taxpayer which outlines the
7 requirements for the Credit, which do not include depreciable "qualified property". Thus, appellant
8 concludes that respondent's inconsistent application demonstrates that R&TC section 23612.2 does not
9 apply only to capital assets. (App. Op. Br., pp. 7-8.)

10 Respondent's Contentions

11 Respondent recites the legislative history of the sales and use tax credit provision. When
12 it was originally enacted in 1985, both the R&TC and the IRC permitted a current deduction for sales
13 taxes paid. However, to avoid the possibility of taxpayers claiming both a deduction and a credit for the
14 same expense, the EZ sales and use tax credit prohibits a taxpayer from taking a current expense
15 deduction and a credit for sales or use tax paid on the same property. The federal Tax Reform Act of
16 1986 repealed the federal current deduction for sales tax paid but allowed for capitalization of sales tax
17 paid in certain circumstances. In 1987, when California law conformed to the federal law repeal of the
18 current deduction for sales tax paid (and the addition of the allowance for capitalization of sales tax
19 paid), the EZ sales and use tax credit was amended to add the current prohibition against adding sales
20 and use tax paid to basis. (Stats. 1987, ch. 1139, § 34.) (Resp. Op. Br., p.3.)

21 In 1996, EZ and program areas were combined and the associated tax incentives were
22 repealed and a new set of incentives for the new EZs were created. According to respondent's
23 contemporaneous legislative analysis, the 1996 legislation added the term "placed in service" to the EZ
24 sales and use tax credit provisions solely for the purpose of clarifying that "qualifying property" must be
25 ready and available for use before the expiration of the EZ designation. (Resp. Op. Br., p.4.)

26 Respondent contends that "placed in service" is a term of art used to describe capital
27 assets and not current expense assets and cites Revenue Ruling 76-238 in support of that contention.
28 Respondent maintains that the term is frequently used in tax statutes and has developed a specialized

1 meaning as referring only to capital assets. For example, respondent cites IRC provisions relating to the
2 deduction for depreciation of an asset which is allowed when the asset is “placed in service.”
3 Respondent also infers that section 23612.2 limits the EZ credit to capitalized property because it
4 prohibits a taxpayer from increasing the basis of property for which EZ credit is claimed. Respondent
5 points out that appellant has failed to identify a single tax statute that unambiguously uses the term
6 “placed in service” in reference to current expense assets. (Resp. Op. Br., pp. 4-5.)

7 In response to appellant’s argument that if the Legislature intended “qualified property”
8 to include only capital assets, it would have so specified as it has done in other statutes, respondent
9 asserts that the other statutes concerns other types of credits and have little bearing on this appeal.
10 Respondent also argues that there is no authority that requires the Legislature to draft statutory language
11 in the same manner for every similar provision.

12 Respondent disputes appellant’s argument that the prohibition in section 23612.2 against
13 increasing “basis” by the sales tax paid applies equally to expensed and capital assets. Respondent
14 acknowledges that IRC section 164(a) applies to both expensed and capital assets; however, when
15 referencing section 164(a), R&TC section 23612.2 specifically provides that a taxpayer is “not entitled
16 to increase the basis of qualified property” for sales tax paid. Respondent asserts that the term “basis”
17 typically refers to a capital asset in the context of income taxation. Respondent also states that the
18 description of “qualified property” set forth in section 23612.2 are assets that “can reasonably be
19 expected to provide multiple years of meaningful use prior to having to be replaced.” (Resp. Op. Br.,
20 pp. 6-7.)

21 Respondent further argues that, in this context, the more logical interpretation is that the
22 term “basis” refers only to capital assets because current expense assets are consumed within a year so
23 resale of such assets would be infrequent and isolated. Respondent concludes that the Legislature would
24 not have expressly prohibited a taxpayer from receiving the EZ credit and deduction for sales tax paid
25 (in the form of depreciation) on capital assets but not current expense assets. (Resp. Op. Br., p.7.)

26 In response to appellant’s contention that respondent has not uniformly applied the
27 capitalization requirement in it audits, respondent states that the auditor’s initial determination was
28 subject to review by her supervisor and that, upon review, the auditor’s misunderstanding was corrected.

1 With respect to the AIPS on which appellant relies to show that respondent allowed the EZ credit for
2 current expense assets, respondent contends that the AIPS does not indicate that auditor was aware that
3 this taxpayer claimed the EZ sales and use tax credit for current expense assets and appellant has not
4 provided any other evidence that would show that auditor was aware. Finally, respondent states that the
5 correspondence cited by appellant does not purport to be a complete listing of all the statutory
6 requirements for allowing EZ sales and use tax credits. In addition, the prior auditor for this taxpayer
7 was aware of the “placed in service” requirement as she made a request for that information during the
8 audit of the taxpayer. (Resp. Op. Br., pp. 7-8.)

9 Appellant’s Reply Brief

10 In its reply brief, appellant asserts that documentation provided with the reply brief shows
11 that respondent’s auditor was aware that the taxpayer for whom appellant submitted the AIPS had
12 claimed machinery parts used for repair and maintenance which were expensed rather than capitalized.
13 Appellant further asserts that respondent’s tax counsel must have been aware or should have been aware
14 of this fact at the hearing based on a brief she prepared in the appeal in that matter (which is attached to
15 appellant’s reply brief). Appellant concludes that its discovery that respondent allowed the EZ credit for
16 expensed property which was based on limited search indicates that respondent may have done so for
17 other taxpayers and, thus, that respondent’s position in this appeal may be a change from past practice.
18 (App. Reply Br., p. 3.)

19 Appellant also contends that respondent misinterprets the meaning of “basis” in that the
20 sales tax paid becomes part of the “cost” of the property, which may be either expensed or capitalized
21 depending upon when the property can be expensed or capitalized. Appellant also disagrees with
22 respondent’s assertion that sales of expensed assets are infrequent, isolated occurrences and contends
23 that business assets are bought and sold all the time so that determining the basis of current expensed
24 assets is a common occurrence. Appellant asserts that such transactions are so common that a U.S.
25 Supreme Court case illustrates the relation of basis to capital gain by explaining that the purchase of an
26 asset for which a taxpayer has taken an “ordinary and necessary expense” deduction will have a zero
27 basis if the taxpayer sells that asset rather than consuming it. (App. Reply Br., p.5.)

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1 Applicable Law

2 R&TC section 23612.2 allows a credit in an amount equal to the sales or use tax paid or
3 incurred in connection with the taxpayer's purchase of qualified property. "Taxpayer" means a
4 corporation engaged in a trade or business within an enterprise zone. (Rev. & Tax. Code, § 23612.2,
5 subd. (b)(1).) "Qualified property" includes many types of tangible property, such as machinery and
6 machinery parts, data processing and communication equipment, and motion picture production
7 equipment. (*Id.*, subd. (b)(2)(A).) Qualified property must be used by the taxpayer exclusively in an
8 enterprise zone. (*Id.*, subd. (b)(2)(C).) Further, qualified property must be "purchased and placed in
9 service" while the enterprise zone is operative. (*Id.*, subd. (b)(2)(D).) The total cost of qualified
10 property that is "purchased and placed in service" in any one year that may be taken into account for
11 purposes of claiming the credit cannot exceed \$20,000,000. (*Id.*, subd. (b)(2)(B).)

12 R&TC section 23612.2, subdivision (e), prevents a double benefit by prohibiting the
13 taxpayer from taking a credit for sales or use tax paid *and* adding that tax to the basis of qualified
14 property. Subdivision (e) states in its entirety:

15 "Any taxpayer who elects to be subject to this section shall not be entitled
16 to increase the basis of the qualified property as otherwise required by
17 section 164(a) of the Internal Revenue Code with respect to sales or use
18 tax paid or incurred in connection with the taxpayer's purchase of
19 qualified property."

18 IRC section 164(a) states, in pertinent part:

19 ". . . there shall be allowed as a deduction state and local . . . taxes . . . paid
20 or accrued within the taxable year in carrying on a trade or business . . .
21 Notwithstanding the previous sentence, . . . any tax which is paid or
22 accrued by the taxpayer in connection with an acquisition . . . of property
23 shall be treated as part of the cost of the acquired property . . ."

24 The objective of statutory interpretation is to ascertain and effectuate legislative intent by
25 giving meaning to every word and phrase in the statute to accomplish a result consistent with the
26 legislative purpose. (*Plaza Hollister Ltd. Partnership v. County of San Benito* (1999) 72 Cal.App.4th 1,
27 35.) Secondly, statutes are given effect according to the usual, ordinary import of the language used in
28 framing them, and where the statutory language is clear and unambiguous, there is no need for
construction. (*People v. Belleci* (1979) 24 Cal.3d 879, 884; *Solberg v. Superior Court* (1977) 19 Cal.3d
182, 198.) If, however, the language supports more than one reasonable interpretation, we look to a

1 variety of extrinsic aids, including the objects to be achieved, the evils to be remedied, legislative
2 history, the statutory scheme of which the statute is a part, contemporaneous administrative construction,
3 and questions of public policy. (*In re Derrick B.* (2006) 39 Cal.4th 535, 539.) Where uncertainty exists,
4 consideration should be given to the consequences that will flow from a particular interpretation. (*Dyna-*
5 *Med, Inc. v. Fair Employment & Housing Com.* (1987) 43 Cal.3d 1379, 1387.)

6 STAFF COMMENTS

7 On rehearing, the parties again attempt to substantiate their respective interpretations of
8 R&TC section 23612.2 in what appears to staff to be the absence of clear language from the Legislature
9 indicating whether the credit is meant to apply only to capital assets or to both capital assets and
10 expensed assets. Appellant first argues that the plain language of R&TC section 23612.2, subdivision
11 (e) is clear on its face and does not limit “qualified property” to capital assets. However, despite the
12 absence of any specific language limiting application of the credit to capital assets, there appears to be
13 sufficient ambiguity in subdivision (e) to require interpretation. In this regard, staff notes that appellant
14 and respondent have both made arguments that the terms “basis” and “placed in service” in the statute
15 should be construed in favor of each party’s position.

16 Appellant also argues that the definition of “qualified property” in other statutes² as
17 including only depreciated property demonstrates that the Legislature did not intend the Credit to be
18 limited to depreciated property in R&TC section 23612.2. Respondent argues that those other statutes
19 “concern different credits and have little bearing on this appeal.” Staff notes that those two statutes
20 allow a credit for a percentage of the cost of the “qualified property” and provide far more detailed
21 requirements and definitions than R&TC section 23612.2, which allows a credit for sale or use tax paid
22 on “qualified property”. At the hearing, respondent should be prepared to discuss and provide support
23 for whether the definition of “qualified property” within the meaning of those two statutes is evidence of
24 any intent by the Legislature to define “qualified property” differently for purposes of R&TC section
25 23612.2.

26 Appellant also points out that R&TC section 23612.2, subdivision (e) references IRC
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28 ² R&TC section 23649 (Manufacturers’ Investment Credit) and R&TC section 23637 (Joint Strike Force Credit).

1 section 164(a), and further notes that IRC section 164(a) deals with both expensed and capitalized
2 property, allowing a current deduction for tax paid on expensed assets and requiring that the tax paid on
3 capitalized assets be added to the basis. Appellant concludes that R&TC section 23612.2, subdivision
4 (e) applies to the deductibility of sales and use tax paid with regard to both expensed and capitalized
5 assets. Appellant appears to assert that, because R&TC section 23612.2, subdivision (e) references *part*
6 of section 164(a), it references *all* of section 164(a). The parties should be prepared to discuss whether
7 by specifically referring to “basis”, R&TC section 23612.2, subdivision (e) narrows the scope of the
8 application of section 164(a) to capitalized assets.³ Further, if as it appears R&TC section 23612.2,
9 subdivision (e) contains no prohibition on deducting the sales or use tax paid on currently expensed
10 assets, the parties should be prepared to discuss whether that subdivision makes sense only in the
11 context of capital assets.

12 Appellant also contends that the Legislature intended “basis” as used in R&TC section
13 23612.2 and “cost” as used in IRC section 164(a) to have the same meaning by incorporation of section
14 164(a). In support of this interpretation, appellant cites IRC section 1012 which provides, in part, that
15 “The basis of property shall be the cost of such property.” Staff notes that the Legislature could have
16 simply used the term “cost” if there was an intention for subdivision (e) to parallel IRC section 164(a);
17 contrariwise the Legislature could simply have clearly set forth a capitalization requirement for qualified
18 property, but it did not do so.

19 *Meaning of “placed in service”*

20 While appellant correctly argues that “placed in service” is a timing term, the phrase
21 (when used in statutes) consistently refers to the time when a capital asset is in a state of readiness and
22 availability for its assigned function. (See Treas. Reg. § 1.167(a)-11(e)(1).) Staff further notes “placed
23 in service” is not a particularly useful or descriptive term when used in the context of current expense
24 assets. The cost of an expensed asset is always deducted in the year in which it is “placed in service.”
25 By contrast, in the context of capital assets, the term “placed in service” provides a point of reference for
26 measuring the length of the asset’s useful life and the timing and amount of depreciation deductions.

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28 ³ Subdivision (e) states that the taxpayer “shall not be entitled to increase the basis of the qualified property as otherwise required by section 164(a)”

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Appellant should be prepared to further address this issue at the oral hearing.

Addition of “placed in service” in the 1997 amendments

Appellant correctly points out that the “placed in service” language was added to section 23612.2 in 1997. This fact may open the possibility that, prior to 1997, the EZ credit did not require that assets be capital in nature. Under that interpretation, appellant’s carryover credits from 1990 through 1996 would be allowed.

The parties agree that the 1997 changes had no substantive effect on the EZ credit statute, but differ on what the statute allowed before 1997. It appears that the prohibition on adding sales or use tax to the basis of qualified property has existed in the EZ credit statute since 1987, which could be an indication that the statute always required (or was always assumed to require) that qualified property be capital in nature. Both parties should address this issue further at the hearing.

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