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BOARD OF EQUALIZATION
STATE OF CALIFORNIA

10 In the Matter of the Appeal of:) **HEARING SUMMARY²**
 11) **CORPORATION FRANCHISE TAX APPEAL**
 12 **LEPRINO FOODS COMPANY¹**) Case No. 481272

	<u>Years Ended</u>	<u>Notice Amounts³</u>
	October 31, 2000	\$807,401
	October 31, 2001	\$330,942
	October 31, 2002	\$4,247,595
	October 31, 2003	\$12,178,175
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18	///	
19	///	

21 ¹ Appellant is headquartered in Denver, Colorado.

22 ² This appeal was originally scheduled for oral hearing at the August 24-26, 2010 Board Meeting. Appellant’s representative
 23 requested a postponement and a prehearing conference, which was held on September 2, 2010. After the prehearing
 24 conference, the parties agreed to a deferment, engaging in further discussion and a possible resolution by settlement. The
 25 appeal was then scheduled for oral hearing at the November 15-16, 2011 Board Meeting and was postponed at the request of
 26 appellant’s representative. The appeal was rescheduled for oral hearing at the December 14-16, 2011 Board Meeting.

27 ³ The amounts listed above correspond to appellant’s total Manufacturer’s Investment Credit (MIC) carryover amount for
 28 each taxable year, as determined by respondent, and as reflected on the Notice of Action dated January 23, 2009. (These
 amounts also correspond to the amounts listed by respondent as “Deficiency” on its opening brief and as “Notice Amounts”
 on its reply brief.) However, the MIC at issue in this appeal for each taxable year are as follows: \$17,795, for the taxable
 year ending October 31, 2000; \$118,029, for the taxable year ending October 31, 2001; \$672,568, for the taxable year ending
 October 31, 2002; and, \$42,020, for the taxable year ending October 31, 2003. These amounts total \$850,412. (App.
 Opening Br., p. 2, fn. 2.)

1 Representing the Parties:

2 For Appellant: Amy Silverstein, Attorney
3 Edwin Antolin, Attorney
4 Charles Olson, Attorney

5 For Franchise Tax Board: Daniel V. Biedler, Tax Counsel III

- 6 QUESTIONS: (1) Whether appellant has shown that its electrical transformer assets are “qualified
7 property” for purposes of Revenue and Taxation Code (R&TC) section 23649,
8 and eligible for the Manufacturer’s Investment Credit (MIC).
9 (2) Whether appellant has shown that its electrical generator assets are “qualified
10 property” for purposes of R&TC section 23649, and eligible for the MIC.
11 (3) Whether appellant has shown that its brick and tile coverings are “qualified
12 property” for purposes of R&TC section 23649, and eligible for the MIC.

13 HEARING SUMMARY

14 Background

15 Respondent completed an audit of appellant for the appeal years, making adjustments to
16 the amounts of the MIC that appellant claimed in these years. Appellant agreed to many of these
17 adjustments, while protesting various amounts disallowed in each of these taxable years.

18 Based upon these audit results, respondent issued a Notice of Proposed Adjusted
19 Carryover Amount (NPACA) dated August 1, 2007. The NPACA was protested and respondent
20 subsequently issued a revised Notice of Action (NOA) for these years dated January 23, 2009, revising
21 the NPACA. This timely appeal followed. (App. Opening Br., p. 2; Exhibits B & C; Appeal Letter,
22 Exhibit A.)

23 Overview

24 Appellant is a manufacturer of cheese, with three plants located in California, the
25 Lemoore East plant, the Lemoore West plant, and the Tracy plant. This appeal concerns all three of
26 these plants and addresses appellant’s entitlement to the MIC for three categories of assets: (1) electrical

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1 transformer assets,⁴ (2) electrical generator assets, and (3) brick and tile coverings (hereafter referred to
2 as “brick and tile assets”). (App. Opening Br., pp. 2-3.)

3 Respondent concluded that appellant is a “qualified taxpayer” for purposes of the MIC
4 statute by virtue of its production of cheese and cheese by-products which, respondent also concluded,
5 constituted a “qualified activity” under the MIC statute. (App. Opening Br., p. 6.) Consequently,
6 respondent allowed the MIC claimed by appellant relating to many of its asset purchases as “qualified
7 property.” Respondent concluded here, however, that appellant’s electrical transformer assets, electrical
8 generator assets, and brick and tile assets were not used primarily in performing appellant’s qualifying
9 activity (i.e., the production of cheese) and, as such, did not meet the requirements as “qualified
10 property” under the statute. Respondent also concluded that appellant’s brick and tile assets were not
11 tangible personal property, another requirement of “qualified property” under R&TC section 23649.
12 (Resp. Opening Br., p. 2.)

13 Pre-Hearing Conference & Post-Conference Briefing

14 On September 2, 2010, a pre-hearing conference was held in this matter. At that time, the
15 three issues (the three asset categories) were discussed. On September 7, 2010, the Appeals Division
16 sent a letter with follow-up questions directed to both parties, requesting a response from respondent
17 first, followed by a response by appellant. The questions posed to the parties are restated below under
18 the applicable issue, followed by the parties’ responses as appropriate.⁵

19 Subsequent to the receipt of the parties’ responses in October and November of 2010, the
20 parties contacted the Appeals Division and expressed their interest in resolving some (or all) of the
21 issues brought forth by the parties at the time of the pre-hearing conference. Consequently, this matter
22 was deferred pending some resolution of the appeal by the parties. In August 2011, the parties contacted
23

24 ⁴ There are no electrical transformer assets at issue at appellant’s Lemoore East plant. (App. Opening Br., p. 4, fn. 3.)

25 ⁵ The Appeals Division requested, among other things from the parties, that appellant provide a diagram or a schematic of
26 one of its plants, which identified the claimed assets and appellant’s manufacturing equipment and which shows how each
27 asset is attached to, or connected with, the manufacturing equipment. Please see Exhibits A and B to appellant’s post-
28 conference brief for appellant’s submission in response to this request. Exhibit A is a schematic diagram of appellant’s
Lemoore West facility and Exhibit B is an aerial photo of that facility. Appellant presented Exhibit B as a means of showing
the location of its electrical generator assets, which are housed in the main factory building. Appellant notes that both its
electrical transformer assets and its electrical generator assets are both connected to the cheese-making equipment by large,
permanently installed power cables. (App. Post-Conference Br., pp. 7-8; App. Post-Conference Br., Exhibits A & B.)

1 the Board Proceedings Division and requested that a hearing be scheduled as the parties were
2 unsuccessful in resolving the appeal.

3 Significantly, at the pre-hearing conference, the parties agreed that the following
4 description reflected appellant's manufacturing process (App. Post-Conference Br., pp. 4-5):⁶

- 5 1. Milk is received via trucks and pumped into large milk silos where the milk is agitated to
6 keep it from separating.
- 7 2. Then milk is run through pasteurization.
- 8 3. Then milk is run through a separator where the cream is removed.
- 9 4. Then starter is added while the milk is transferred to the churning vats.
- 10 5. The churning process (cooking and coagulating) is completed in the churning vats turning
11 the milk into curds and whey.
- 12 6. The whey is drawn off-leaving the curds.
- 13 7. The curds go through the DMZ machine which presses the cheese to remove additional
14 liquid and standardizes the pH of the cheese, creating loose ribbons of cheese.
- 15 8. The loose ribbons are run through the extruder (mold-like machine) to form more solid
16 ribbons of cheese.
- 17 9. Ribbons of cheese go through brine belt where salt is added and cheese is cooled.
- 18 10. Now ribbon of cheese is cut in bulk pieces and further processed such as dicing, grating,
19 or shredding.
- 20 11. The cheese is then processed as requested by customer and boxed (whether frozen, gas
21 flushed or fresh).

22 In addition, prior to the pre-hearing conference, there were two sub-issues in dispute
23 relating to the third issue in this matter (whether the brick and tile assets were "qualified property"). At
24 the pre-hearing conference, respondent stated and confirms below, that it no longer disputes that the
25 brick and tile assets are used primarily in a qualified activity. Consequently, the portion of the parties'
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27 ⁶ At the pre-hearing conference, the Appeals Division presented the parties with this description of appellant's manufacturing
28 process, which the Appeals Division replicated from respondent's December 5, 2008 protest correspondence letter to
appellant (App. Opening Br., Exhibit C, p. 7.) At the pre-hearing conference, the parties agreed that this description
accurately reflected appellant's manufacturing process.

1 briefing, relating to that sub-issue, is not reflected in this hearing summary. The following remains in
2 dispute relating to the third issue: whether the brick and tile assets are tangible personal property and,
3 thus, are qualified property under the MIC statute.

4 **Issue 1: Whether appellant has shown that its electrical transformer assets are “qualified**
5 **property” for purposes of R&TC section 23649, and eligible for the MIC.**

6 The issue relating to these assets is whether the assets are used primarily in a qualified
7 activity and, thus, are qualified property under the MIC statute.

8 Appellant’s electrical transformer assets are described as follows. Appellant purchases
9 bulk power, supplied by means of a 115 kilovolt (KV) high voltage line, as the purchase of 115 KV of
10 electricity is more economical than the purchase of 70 KV of electricity. The electricity from the 115
11 KV line must be transformed, via appellant’s electrical transformer assets, to a lower voltage for use by
12 appellant’s cheese-processing equipment. These assets include a high voltage switch structure, a fuse
13 structure, a main transformer, a low voltage structure, and a switchgear. Additionally, switchgears,
14 transformers, and power lines are used to further modify voltage levels and to connect the main
15 transformer to the cheese-processing equipment. (App. Opening Br., pp. 3-4.)

16 Contentions

17 Appellant’s Contentions

18 Appellant contends that its electrical transformer assets are primarily used in appellant’s
19 manufacturing process and, as a result, are qualified property under R&TC section 23649, subdivision
20 (d)(1)(A). (App. Opening Br., p. 7.) Appellant asserts that the primary use of the electrical transformer
21 assets is to convert electricity to a form that the cheese-processing equipment can use. Appellant also
22 asserts that over 90 percent of the electricity that runs through the electrical transformer assets is directly
23 used to operate the cheese-processing equipment. (App. Opening Br., p. 4.)

24 Appellant states that, under R&TC section 23649, subdivision (e)(5), the term
25 “primarily” is defined as “tangible personal property used 50 percent or more of the time” in a
26 qualifying activity. Based upon this definition, appellant asserts that, pursuant to R&TC section 23649,
27 subdivision (d)(1)(A), qualified property includes tangible personal property that is used 50 percent or
28 more of the time for the process of manufacturing property. Appellant further asserts that this process is

1 defined by the statute as the period of time beginning at the point at which raw materials are stored on
2 the same premises where the manufacturing activity is conducted and ending at the point in which the
3 product manufactured is placed into packaging. (App. Opening Br., p. 8.)

4 Appellant contends that the electrical transformer assets are used to transform electricity
5 for cheese manufacturing far more than 50 percent of the time that these assets are in operation. In other
6 words, appellant contends that during far more than 50 percent of the time that the electrical transformer
7 assets are in operation, raw materials (i.e., milk) are processed into cheese and packaged. Accordingly,
8 appellant argues that these assets fall squarely within the provisions of R&TC section 23649,
9 subdivision (d)(1)(A), and are qualified property for purposes of the MIC. (App. Opening Br., pp. 8-9.)

10 Appellant asserts that respondent's conclusion that the electrical transformer assets are
11 not used in the manufacturing process (i.e., from the time that milk is loaded into the plants' silos until
12 the time that cheese is packaged), and only used prior to the manufacturing process, is inaccurate.
13 Appellant asserts that the transformer assets are used during this full span of time because, without these
14 assets, the cheese-processing equipment would not have the large amounts of electricity needed for
15 operation. Moreover, appellant contends that, if the electrical transformer assets were not used during
16 this period of time, appellant would have no need for these assets. (App. Opening Br., p. 10; App. Reply
17 Br., pp. 2-4.)

18 Appellant argues that case law supports appellant's position. Citing the *Appeal of Save*
19 *Mart Supermarkets & Subsidiary (Save Mart)* 02-SBE-002, Feb. 6, 2002, appellant states that the MIC
20 legislation is supposed to be interpreted liberally in favor of taxpayers to effectuate the purpose of the
21 legislation—manufacturing in California. In addition, appellant asserts that in *Scott Paper Co. (Scott*
22 *Paper)* (1980) 74 T.C. 137, the Tax Court determined that assets substantially similar to appellant's
23 electrical transformer assets were tangible personal property that qualified for the investment tax credit.
24 Appellant states that the Tax Court found that the taxpayer's primary electrical improvements were
25 closely related to the increased production of the facility and were used as an integral part of the
26 taxpayer's manufacturing. While acknowledging that the MIC and the federal investment tax credit
27 differ, appellant asserts that the Tax Court applied a higher standard in finding that the assets were used
28 as an integral part of the taxpayer's manufacturing process. (App. Opening Br., pp. 11-12.)

1 Appellant also contends that two unpublished Board decisions, the *Appeal of Foster*
2 *Poultry Farms (Foster Poultry Farms)*, Case number 268417, 2006 Cal. Tax. LEXIS 147, and the
3 *Appeal of Sierra Pacific Industries (Sierra Pacific)*, Case number 286309, 2005 Cal. Tax. LEXIS 406,
4 also support its position. Appellant asserts that the Board in *Foster Poultry Farms* also addressed
5 transformer assets, considered the issue of “use” in the manufacturing process, and found that the
6 taxpayer’s assets satisfied the requirements of the MIC statute. Appellant asserts that the Board found
7 that the taxpayer in *Foster Poultry Farms* could not process poultry without its substation/power
8 distribution property and that, because the property was used in the qualified activity of poultry
9 processing, the substation/power distribution property was qualified property for purposes of the MIC.
10 (App. Opening Br., p. 12.) Appellant asserts that the Board reached a similar conclusion in *Sierra*
11 *Pacific* for that taxpayer’s co-generation assets. (App. Opening Br., pp. 12-13.) Appellant
12 acknowledges that these unpublished decisions are not binding on the Board. Nevertheless, appellant
13 argues that, because the Board’s decision in *Foster Poultry Farms* is almost identical to the present
14 dispute, the Board would be acting arbitrarily to reach a result different than that concluded in *Foster*
15 *Poultry Farms*. (App. Opening Br., p. 13.)

16 In its reply brief, appellant disagrees with respondent’s position that, because appellant’s
17 electrical transformer assets do not touch the cheese (i.e., come into physical contact with the raw
18 materials), such assets are not used in the manufacturing process. Appellant contends that respondent
19 cites no legal authority to support such a requirement. Appellant asserts that there is no statutory
20 requirement of physical contact and that its electrical transformer assets nevertheless play an
21 indispensable role in converting the raw materials into the finished product—a use in the manufacturing
22 process. Appellant contends that, by adding such a requirement, respondent is arbitrarily seeking to
23 limit the scope of the MIC, which is contrary to the clear intention and express direction of the
24 Legislature. (App. Reply Br., pp. 1, 4-5.)

25 In its supplemental brief, appellant references the statutory definitions of
26 “manufacturing” and “processing” and asserts that, under R&TC section 23649, subdivision (d)(1)(A),
27 tangible personal property is considered qualified property if it is primarily used for either the
28 “manufacturing . . . of property” or for the “processing . . . of property.” In doing so, appellant disputes

1 respondent's assertions that there is a physical touching or proximity requirement in R&TC section
2 23649, subdivision (d)(1)(A). Instead, appellant argues that no such requirement exists under the
3 definition of "processing" and that, even if such a requirement did exist, appellant would still meet the
4 requirements for a qualified activity because the electrical transformer assets are part of appellant's
5 "manufacturing." (App. Supp. Br., p. 4.)

6 Appellant next asserts that the term "process," as part of the "manufacturing process," is
7 defined in R&TC section 23649, subdivision (e)(6), by reference to a period of time (i.e., "the period
8 beginning at the point . . . and ending at the point"). Consequently, appellant argues that the definition
9 of "process" does not impose a physical connection or proximity requirement on property eligible for
10 the MIC as alleged by respondent. Appellant instead asserts that its electrical transformer assets are
11 used during the manufacturing process (i.e., during the period beginning at the point at which trucks
12 offload milk into silos and ending at the point at which cheese is packaged). In conclusion, appellant
13 contends that respondent's assertion of temporal and physical requirements lack force and that it is
14 irrelevant whether the assets physically touch the products manufactured. (App. Supp. Br., pp. 4-7.)

15 Respondent's Contentions

16 Respondent states that appellant's electrical transformer assets transform or reduce the
17 electricity received by appellant on 115 KV lines to 12.47 KV of electricity, at which level the
18 electricity can be used to safely run appellant's processing machinery and which, respondent contends,
19 occurs prior to the actual manufacturing process. Consequently, respondent contends that the issue is
20 whether these assets are used primarily in performing a qualified activity. (Resp. Opening Br., p. 4.)

21 Respondent asserts that cheese processing does not begin until after: (1) the conversion
22 of electricity to a level that appellant can safely introduce it to its processing machinery; and (2) the
23 electricity is transported to the location of the processing machinery until the cheese is completed. Thus,
24 respondent contends that these assets are not used primarily within the processing activity (i.e.,
25 appellant's qualified activity). Further, respondent contends that the electrical transformer assets do not
26 come into physical contact with the raw materials (milk) or the intermediate or finished products (whey
27 and lactose). Thus, respondent concludes that the electrical transformer assets do not actually convert
28 the raw materials into finished products. (Resp. Opening Br., p. 4.)

1 In addition, respondent asserts that the electrical transformer assets are physically
2 separated from the raw materials from beginning to end in the processing of the raw materials into
3 finished products, causing these assets to be used primarily outside of the boundaries of the process of
4 transforming milk. Thus, respondent concludes that the electrical transformer assets do not satisfy the
5 definition of “qualified property,” as defined in R&TC section 23649, subdivision (d), as the activity for
6 which the assets are used primarily (i.e., the conversion of electricity) is not a “qualified activity” as
7 defined in California Code of Regulations, title 18, section (Regulation) 23649-2(n). (Resp. Opening
8 Br., pp. 4-5.)

9 Respondent argues that appellant has mistakenly placed a heavy reliance on the
10 qualification of property for the federal investment tax credit as equating to the qualification of that
11 same property for the MIC. Consequently, respondent contends that appellant’s reliance on *Scott Paper*
12 is inappropriate, as the federal investment tax credit, which is addressed in that case, does not have the
13 same requirements as the MIC. (Resp. Reply Br., pp. 2-3, fn. 7.) Respondent contends that, to qualify
14 for the federal investment tax credit, the Internal Revenue Code provides that tangible personal property
15 must be used as an “integral part” of certain qualifying activities. Respondent asserts that appellant has
16 taken this “integral part” requirement under federal law and argued that as long as equipment is
17 indispensable and used simultaneously with the processing of physical materials, the equipment is
18 qualified property for purposes of the MIC. However, respondent contends that whether property
19 qualifies for the federal investment tax credit by virtue of being an integral part of a qualifying activity is
20 not sufficient, as the property must meet the requirements for the MIC under California law. (Resp.
21 Reply Br., p. 3.)

22 Respondent instead asserts that the assets at issue must satisfy the requirement of R&TC
23 section 23649, subdivision (d)(1)(A), such that “tangible personal property be used [in a qualified
24 activity] beginning at the point at which any raw materials are received by the qualified taxpayer and
25 introduced into the process” Respondent contends that the statute requires both a temporal and
26 physical connection of property to the qualifying activity to satisfy the requirements as qualified
27 property, citing the terms “process” and “processing” as defined in R&TC section 23649 and as defined
28 in Regulation 23649-2. (Resp. Reply Br., pp. 3-4.) Respondent asserts that appellant’s electrical

1 transformer assets do not satisfy both the temporal and physical requirements of the MIC. Respondent
2 states that the assets are located outside of the buildings in which milk processing occurs, connected by
3 wire. Further, respondent asserts that the electrical transformer assets produce electricity which is not
4 itself applied to the raw materials in the processing of milk, but is an intermediary between the electrical
5 transformer assets and the raw materials and that the process of conditioning the electricity from the
6 supplier occurs before or outside of the period and physical space of the processing of milk. (Resp.
7 Reply Br., p. 4.)

8 Post-Conference Briefing

9 The following questions were posed to the parties:

10 Respondent

- 11 (1) Regarding the transformer assets, please explain respondent's position that such assets must
12 be attached to the manufacturing equipment in order to be considered used in the
13 manufacturing process? Please explain this in light of respondent's concession that these
14 assets are connected to the manufacturing equipment by electrical wiring. As part of this
15 discussion, please also explain how the transformer assets are "two steps removed" from the
16 manufacturing equipment. Please also include in the discussion respondent's reliance upon
17 the definition of "processing" as provided by Regulation 23649-2.⁷

18 Appellant

- 19 (1) Please describe the manufacturing process. The description should include and specify at
20 which stages of manufacturing the claimed assets are used (and how that equipment is used
21 in the manufacturing process), including when the use of each piece of equipment begins
22 and when the use of each piece of equipment ends.

23 Respondent's Contentions

24 Respondent first addresses the question posed by summarizing the definition of two
25 terms: manufacturing and processing. (Resp. Post-Conference Br., p. 2.) R&TC section 23649,
26

27 ⁷ Regulation 23649-2, subdivision (m), defines the term "processing" as "the process of physically applying the materials and
28 labor necessary to modify or change the characteristics of property." R&TC section 23649, subdivision (e)(7), provides a
similar definition of this term.

1 subdivision (e)(3), defines “manufacturing” as “the activity of converting or conditioning property by
2 changing the form, composition, quality, or character of the property for ultimate sale at retail or use in
3 the manufacturing of a product to be ultimately sold at retail. Manufacturing includes any
4 improvements to tangible personal property that result in a greater service life or greater functionality
5 than that of the original property.” R&TC section 23649, subdivision (e)(7), defines “processing” as
6 “the physical application of the materials and labor necessary to modify or change the characteristics of
7 property.”

8 Respondent states that, in order to be qualified property, assets must be “used in” a
9 qualified activity (i.e., manufacturing or processing).⁸ Respondent contends that the question presented
10 here is whether assets that condition electricity from the grid are “used in” transforming milk into
11 cheese, whey, and lactose products. Respondent argues that, unless the assets convert or condition milk,
12 by changing its form, composition, quality, or character (i.e., manufacturing) or physically apply
13 materials and labor necessary to modify or change the characteristics (i.e., processing) of milk, such
14 assets are not qualified property. (Resp. Post-Conference Br., p. 2.)

15 Respondent further argues that the electrical assets do not actually participate physically
16 in the application of materials or labor to milk, nor do the assets change the form, composition, quality,
17 or character of milk into finished cheese, whey, or lactose products. Respondent notes that the electrical
18 transformer assets are located outside of the buildings in which milk processing occurs, connected by
19 wires. Respondent states that the action of the electrical assets is on electricity, which is not itself
20 applied to raw materials in the processing of milk, but is an intermediary (through conducting wires)
21 between the power equipment and the milk. As such, respondent argues that the electrical assets can be
22 said to be two steps removed from the manufacturing or processing of milk into cheese, whey, or lactose
23 products. (Resp. Post-Conference Br., pp. 2-3.)

24 Respondent references a Massachusetts Department of Revenue letter ruling (Letter
25 Ruling 01-6 dated August 17, 2001), which includes a discussion of the qualification of property use in
26 manufacturing for an exemption from sales tax. Respondent alleges that the Massachusetts’s statute is
27

28 ⁸ Respondent alleges that appellants’ activities relating to milk do not constitute “refining, fabricating, or recycling of property” as those terms are used in R&TC section 23649 and its accompanying regulations.

1 similar to the statute at issue here and that both statutes focus on the primary use of property in the
2 manufacture or processing of tangible personal property to be sold. Regarding the Massachusetts's
3 statute, respondent states that property qualifying for the exemption had to effect physical change on the
4 property to be sold or had to actively cause a physical change to a condition that, in turn, caused a
5 physical change to the tangible personal property to be sold. In the letter ruling, the Massachusetts
6 Department of Revenue discusses the five definitions of exempt uses of machinery as (Resp. Post-
7 Conference Br., p. 3):

8 . . . machinery shall be deemed to be used directly and exclusively in the actual
9 manufacture, conversion or processing of tangible personal property to be sold only
10 where such machinery is used solely during a manufacturing, conversion or processing
11 operation [1] to effect a direct and immediate physical change upon the tangible personal
12 property to be sold; [2] to guide or measure a direct and immediate physical change upon
13 such property where such function is an integral and essential part of tuning, verifying or
14 aligning the component parts of such property; or [3] to test or measure such property
15 where such function is an integral part of the production flow or function; used solely [4]
16 to store, transport, convey or handle such property during the manufacturing, converting,
17 or processing operations heretofore specified; or used solely [5] to play such property in
18 the container, package or wrapping in which such property is normally sold to the
19 ultimate consumer thereof.

15 Appellant's Contentions

16 Appellant first criticizes respondent's citation of the Massachusetts Department of
17 Revenue letter ruling which, appellant argues, applies a foreign state's laws and a different legal
18 standard. Appellant notes that the Massachusetts ruling held that all of the assets for which the
19 exemption was claimed qualified for the exemption. Appellant further notes that the clean room
20 equipment at issue in the letter ruling did not come into physical contact with the items being produced,
21 but that the clean room equipment was nevertheless essential to the production process and the
22 manufacture of items being produced. Appellant asserts that the Massachusetts ruling is directly
23 contrary to respondent's position that the electrical assets must physically participate in the processing
24 of the raw materials into finished products and that, without such interaction, the electrical assets were
25 not used primarily in the manufacturing process. Appellant contends that, although the electrical
26 transformer assets do not come into physical contact with the cheese which it produces, these assets are
27 nonetheless essential to the manufacturing process because, without the suitable electricity, it would be
28 impossible to manufacture appellant's products. Appellant then goes on to argue that it makes little

1 sense to follow a non-binding Massachusetts letter ruling when pertinent authorities are available, citing
2 the *Appeal of Foster Poultry Farms, supra, Scott Paper Co., supra, and Hospital Corp. of America &*
3 *Subsidiaries (Hospital Corp.)* (1997) 109 T.C. 21.⁹ (App. Post-Conference Br., pp. 2-3.)

4 As to the post-conference question posed to appellant regarding the manufacturing
5 process, appellant cites the definitions of “manufacturing” and “process” in Regulation 23649-2 and
6 asserts that the “manufacturing process,” as defined by the regulations, refers to a period of time or a
7 “window” during which certain activities are performed. Appellant states that it agrees with
8 respondent’s characterization of the manufacturing process of this activity as “the process when the
9 trucks offload milk into milk silos at the manufacturing site. The process is completed when appellant
10 has packaged the final product.” (App. Post-Conference Br., p. 4.)

11 Appellant states that the electrical transformer assets are used to transform bulk
12 purchased, high voltage electricity to a lower voltage electricity of the sort necessary to run the
13 machinery located in the factory. Appellant further states that the electrical transformer assets are used
14 at all times during the manufacturing process (i.e., during all eleven of the steps in the manufacturing
15 process summarized above). Appellant argues that each of the eleven steps requires electricity and that
16 electricity in a form useable by appellant’s cheese-making equipment is only available through the use
17 of its electrical transformer assets. Without these assets, appellant asserts that it could not produce
18 cheese. (App. Post-Conference Br., p. 4.)

19 Finally, appellant asserts that neither R&TC section 23649 or its accompanying
20 regulations include the requirement that assets must be “attached to” other manufacturing equipment in
21 order to qualify for the MIC. Appellant argues that appellant has failed to support its position to the
22 contrary. Appellant asserts that its electrical transformer assets are part of the process of converting or
23 conditioning property (i.e., milk) by changing the form, composition, quality, or character of the
24 property (into cheese) and that, if these assets ceased to function properly, the manufacture of cheese
25 would come to a halt. (App. Post-Conference Br., p. 8.)

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27 _____
28 ⁹ The *Hospital Corp.* decision is discussed in the third issue below (relating to the brick and tile assets).

1 Applicable Law

2 The MIC provides an income tax credit to any qualified taxpayer for specified qualified
3 costs paid or incurred on or after January 1, 1994, for qualified property placed into service in this
4 state. (Rev. & Tax. Code, § 23649, subd. (a)(1); Cal. Code Regs., tit. 18, § 23649-1, subd. (a).) The
5 Board has held that the MIC should be interpreted liberally in favor of taxpayers (see *Appeal of Save*
6 *Mart, supra; Appeal of California Steel Industries, Inc.* 2003-SBE-001A, July 9, 2003).

7 R&TC section 23649, subdivision (d), defines “qualified property” as follows:

8 (1) Tangible personal property that is defined in Section 1245(a) of the Internal Revenue
9 Code for use by a qualified taxpayer in those lines of business described in Codes 2011 to
10 3999, inclusive, of the Standard Industrial Classification (SIC) Manual published by the
United States Office of Management and Budget, 1987 edition, that is primarily used for
any of the following:

- 11 (A) For the manufacturing, processing, refining, fabricating or recycling of
12 property, beginning at the point at which any raw materials are received by
13 the qualified taxpayer and introduced into the process and ending at the point
at which the manufacturing, processing, refining, fabricating, or recycling has
altered tangible personal property to its completed form, including packaging,
if required . . . ”
14 (B) . . .
15 (C) To maintain, repair, measure, or test any property described in this paragraph.
16 (D) . . .
17 (E) . . .
(Underlines added).

18 Regulation 23649-2, subdivision (n), defines the term “qualified activity” as:

19 . . . an activity engaged in by a qualified taxpayer that involves manufacturing,
20 processing, refining, fabricating, recycling, research and development, or pollution
21 control, and shall also include the maintenance, repairing, measuring, or testing of any
22 qualified property.

23 R&TC section 23649, subdivision (e)(5), defines the term “primarily” as “tangible
24 personal property used 50 percent or more of the time in an activity described in subdivision (d).” More
25 specifically, Regulation 23649-2, subdivision (k), defines the term “primarily” as meaning:

26 . . . that property is used 50 percent or more of the time in any qualified activity. For
27 purposes of the preceding sentence, the term “time” shall mean the total number of hours
28 that the property is actually in use during the 12-month period immediately following the
date the property is placed in service in this state. For example, if an item of property is
used by a qualified taxpayer for a total of 100 hours for all uses during the 12-month
period immediately following the date the property is placed in service in this state, then
“primarily” used in a qualified activity means at least 50 hours of the property’s use is in
a qualified activity.

 R&TC section 23649, subdivision (e)(3), defines “manufacturing” as:

1 . . . the activity of converting or conditioning property by changing the form,
2 composition, quality, or character of the property for ultimate sale at retail or use in the
manufacturing of a product to be ultimately sold at retail. . . .

3 R&TC section 23649, subdivision (e)(6), defines the term “process” as:

4 . . . the period beginning at the point at which any raw materials are received by the
5 qualified taxpayer and introduced into the manufacturing, processing, refining,
6 fabricating, or recycling activity of the qualified person and ending at the point at which
7 the manufacturing, processing, refining, fabricating, or recycling activity of the qualified
8 taxpayer has altered tangible personal property to its completed form, including
9 packaging, if required. Raw materials shall be considered to have been introduced into
the process when the raw materials are stored on the same premises where the qualified
taxpayer’s manufacturing, processing, refining, fabricating, or recycling activity is
conducted. Raw materials that are stored on premises other than where the qualified
taxpayer’s manufacturing, processing, refining, fabricating, or recycling activity is
conducted, shall not be considered to have been introduced into the manufacturing,
10 processing, refining, fabricating, or recycling process.”

11 R&TC section 23649, subdivision (e)(7), defines “processing” as “the physical
12 application of the materials and labor necessary to modify or change the characteristics of property.”

13 STAFF COMMENTS

14 The parties should be prepared to address whether it is necessary for qualified property to
15 “physically participate” in the processing of the raw materials (the milk) into the finished product (the
16 cheese) and, if so, to describe the manner in which such physical participation must occur. The parties
17 should also be prepared to address whether the location of the transformer assets outside of the building
18 or buildings in which manufacturing takes place has any bearing on the determination of those assets as
19 qualified property.

20 **Issue 2: Whether appellant has shown that its electrical generator assets are “qualified property”** 21 **for purposes of R&TC section 23649, and eligible for the MIC.**

22 The issue relating to these assets is whether the assets are used primarily in a qualified
23 activity and, thus, are qualified property under the MIC statute.

24 Appellant’s electrical generator assets are described as follows. The electrical generator
25 assets are large, portable generators which appellant uses to maintain its equipment in case of power
26 outages. The generators provide back-up power to permit the emptying of appellant’s production vats to
27 avoid damage to the machines and to maintain sanitary conditions. If power is cut off while appellant’s
28 cheese-processing equipment is being operated, the food product which is only part way through the

1 cheese-making process can solidify and damage the equipment. (App. Opening Br., p. 4.)

2 Contentions

3 Appellant's Contentions

4 Appellant contends that its electrical generator assets are primarily used in appellant's
5 manufacturing process and, as a result, are qualified property under R&TC section 23649, subdivision
6 (d)(1)(A). Appellant also contends that these assets are qualified property under R&TC section 23649,
7 subdivision (d)(1)(C), because the assets are used to maintain appellant's manufacturing equipment.
8 (App. Opening Br., p. 7.)

9 Appellant asserts that its cheese-processing equipment requires maintenance and
10 protection and that the equipment can be damaged if power is lost while the equipment is operating.
11 Consequently, appellant asserts that, to provide for the proper maintenance of its equipment in case of
12 power outages, it purchased emergency generators. (App. Opening Br., p. 4, 7.) While appellant admits
13 that the generators are not operated as a matter of course during the manufacturing process, appellant
14 argues that its electrical generator assets only use comes during the manufacturing process between the
15 introduction of the raw materials and the completion of the finished product. Consequently, appellant
16 contends that the electrical generator assets are qualified property under R&TC section 23649,
17 subdivision (d)(1)(A). (App. Opening Br., pp. 13-14; App. Reply Br., p. 6.) Appellant also argues that,
18 even though the electrical generator assets do not "apply force to the milk" as alleged by respondent, the
19 assets are nevertheless primarily used in the manufacturing process under R&TC section 23649,
20 subdivision (d)(1)(A), and are qualified property for purposes of the MIC. (App. Supp. Br., pp. 7-8.)

21 Appellant also asserts that the electrical generator assets are qualified property under
22 R&TC section 23649, subdivision (d)(1)(C), which applies to tangible personal property primarily used
23 to "maintain, repair, measure, or test" qualified property. Appellant contends that, because the sole
24 purpose of its electrical generator assets is to serve a maintenance function, these assets are primarily
25 used to maintain qualified property and, thus, are qualified property for this reason as well. Appellant
26 argues that to find otherwise is contrary to the intent of the MIC statute and discourages other
27 manufacturers from taking appropriate measures to protect their equipment in California. (App.
28 Opening Br., p. 14; App. Reply Br., p. 6.)

1 Respondent’s Contentions

2 Respondent states that appellant’s electrical generator assets only use is to produce
3 energy sufficient to operate portions of the machinery in order to clear and avoid damage to the
4 machinery that could result if the milk-based materials cooled and hardened during a power outage.
5 Consequently, similar to appellant’s electrical transformer assets, respondent contends that the issue is
6 whether these assets are used primarily in performing a qualified activity. (Resp. Opening Br., p. 5.)

7 Respondent asserts that even if the electrical generator assets are used to produce
8 electricity in the case of a power outage, the assets are not actually manipulating the physical product
9 and, as such, are not used primarily in the actual manufacturing process, as defined in Regulation 23649-
10 2, subdivision (e). (Resp. Opening Br., p. 5.) In addition, respondent asserts that the electrical generator
11 assets are not qualified property under R&TC section 23649, subdivision (d)(1)(C), because the assets
12 do not “maintain” any qualified property. Instead, respondent contends that the electrical generator
13 assets are used primarily to stand by and be ready to power certain of appellant’s assets which are
14 qualified property—tangible personal property that actually touches the raw materials as the raw
15 materials are processed into finished products. Respondent contends that the electrical generator assets
16 do not “hold or keep” appellant’s qualified property “in any particular state or condition” and do not
17 affect, change, repair, or otherwise alter or “maintain” the condition of appellant’s qualified property.
18 Consequently, respondent concludes that the electrical generator assets do not satisfy the definition of
19 “qualified property,” as defined in R&TC section 23649, subdivision (d), as the activity for which the
20 assets are used primarily (i.e., standing by to power certain equipment during a power outage) is not a
21 “qualified activity” as defined in Regulation 23649-2, subdivision (n). (Resp. Opening Br., pp. 5-6.)

22 Respondent argues that appellant has mistakenly placed a heavy reliance on the
23 qualification of property for the federal investment tax credit as equating to the qualification of that
24 same property for the MIC. Consequently, respondent contends that appellant’s reliance on *Scott Paper*
25 is inappropriate, as the federal investment tax credit, which is addressed in that case, does not have the
26 same requirements as the MIC. (Resp. Reply Br., pp. 2-3, fn. 7.) Respondent contends that, to qualify
27 for the federal investment tax credit, the Internal Revenue Code provides that tangible personal property
28 must be used as an “integral part” of certain qualifying activities. Respondent asserts that appellant has

1 taken this “integral part” requirement under federal law and argued that as long as equipment is
2 indispensable and used simultaneously with the processing of physical materials, the equipment is
3 qualified property for purposes of the MIC. However, respondent contends that whether property
4 qualifies for the federal investment tax credit by virtue of being an integral part of a qualifying activity is
5 not sufficient, as the property must meet the requirements for the MIC under California law. (Resp.
6 Reply Br., p. 3.)

7 Respondent instead asserts that the assets at issue must satisfy the requirement of R&TC
8 section 23649, subdivision (d)(1)(A), such that “tangible personal property be used [in a qualified
9 activity] beginning at the point at which any raw materials are received by the qualified taxpayer and
10 introduced into the process” Respondent contends that the statute requires both a temporal and
11 physical connection of property to the qualifying activity to satisfy the requirements as qualified
12 property, citing the terms “process” and “processing” as defined in R&TC section 23649 and as defined
13 in Regulation 23649-2. (Resp. Reply Br., pp. 3-4.) Respondent asserts that appellant’s electrical
14 generator assets do not satisfy both the temporal and physical requirements of the MIC. Respondent
15 contends that, although these assets are physically adjacent to the equipment which is physically
16 applying force to the milk, the electrical generator assets, if ever used, operate to provide electricity to
17 machines in physical contact with the milk to provide for its disposal. (Resp. Reply Br., p. 4.)

18 Post-Conference Briefing

19 The following questions were posed to the parties:

20 Respondent

- 21 (1) Regarding the generator assets, please explain respondent’s position that such assets must be
22 attached to the manufacturing equipment in order to be considered used in the manufacturing
23 process? Please explain this in light of respondent’s concession that these assets are
24 connected to the manufacturing equipment by electrical wiring. Please also include in the
25 discussion respondent’s reliance upon the definition of “processing” as provided by
26 Regulation 23649-2.
- 27 (2) Regarding the generator assets, what is respondent’s position regarding the applicability of
28 R&TC section 23649, subdivision (d)(1)(C) (i.e., to “maintain, repair, measure, or test”), for

1 those assets to be considered “qualified property”?

2 Appellant

3 (1) Please describe the manufacturing process. The description should include and specify at
4 which stages of manufacturing the claimed assets are used (and how that equipment is used
5 in the manufacturing process), including when the use of each piece of equipment begins
6 and when the use of each piece of equipment ends.

7 Respondent’s Contentions

8 Respondent first addresses the question posed by summarizing the definition of two
9 terms: manufacturing and processing. (Resp. Post-Conference Br., p. 2.) R&TC section 23649,
10 subdivision (e)(3), defines “manufacturing” as “the activity of converting or conditioning property by
11 changing the form, composition, quality, or character of the property for ultimate sale at retail or use in
12 the manufacturing of a product to be ultimately sold at retail. Manufacturing includes any
13 improvements to tangible personal property that result in a greater service life or greater functionality
14 than that of the original property.” R&TC section 23649, subdivision (e)(7), defines “processing” as
15 “the physical application of the materials and labor necessary to modify or change the characteristics of
16 property.”

17 Respondent states that, in order to be qualified property, assets must be “used in” a
18 qualified activity (i.e., manufacturing or processing).¹⁰ Respondent contends that the question presented
19 here is whether assets that stand by to generate electricity in case of a power failure are “used in”
20 transforming milk into cheese, whey, and lactose products. Respondent argues that, unless the assets
21 convert or condition milk, by changing its form, composition, quality, or character (i.e., manufacturing)
22 or physically apply materials and labor necessary to modify or change the characteristics (i.e.,
23 processing) of milk, such assets are not qualified property. (Resp. Post-Conference Br., p. 2.)

24 Respondent further argues that the electrical assets do not actually participate physically
25 in the application of materials or labor to milk, nor do the assets change the form, composition, quality,
26 or character of milk into finished cheese, whey, or lactose products. Respondent notes that the electrical
27

28 ¹⁰ Respondent alleges that appellants’ activities relating to milk do not constitute “refining, fabricating, or recycling of property” as those terms are used in R&TC section 23649 and its accompanying regulations.

1 generator assets are situated to the side within the factory building, connected to certain items of
2 manufacturing equipment by wires. Respondent states that the action of the electrical assets is on
3 electricity, which is not itself applied to raw materials in the processing of milk, but is an intermediary
4 (through conducting wires) between the power equipment and the milk. As such, respondent argues that
5 the electrical assets can be said to be two steps removed from the manufacturing or processing of milk
6 into cheese, whey, or lactose products. (Resp. Post-Conference Br., pp. 2-3.)

7 Respondent references a Massachusetts Department of Revenue letter ruling (Letter
8 Ruling 01-6 dated August 17, 2001), which includes a discussion of the qualification of property use in
9 manufacturing for an exemption from sales tax. Respondent alleges that the Massachusetts's statute is
10 similar to the statute at issue here and that both statutes focus on the primary use of property in the
11 manufacture or processing of tangible personal property to be sold. Regarding the Massachusetts's
12 statute, respondent states that property qualifying for the exemption had to effect physical change on the
13 property to be sold or had to actively cause a physical change to a condition that, in turn, caused a
14 physical change to the tangible personal property to be sold. In the letter ruling, the Massachusetts
15 Department of Revenue discusses the five definitions of exempt uses of machinery as (Resp. Post-
16 Conference Br., p. 3):

17 . . . machinery shall be deemed to be used directly and exclusively in the actual
18 manufacture, conversion or processing of tangible personal property to be sold only
19 where such machinery is used solely during a manufacturing, conversion or processing
20 operation [1] to effect a direct and immediate physical change upon the tangible personal
21 property to be sold; [2] to guide or measure a direct and immediate physical change upon
22 such property where such function is an integral and essential part of tuning, verifying or
23 aligning the component parts of such property; or [3] to test or measure such property
24 where such function is an integral part of the production flow or function; used solely [4]
25 to store, transport, convey or handle such property during the manufacturing, converting,
26 or processing operations heretofore specified; or used solely [5] to play such property in
27 the container, package or wrapping in which such property is normally sold to the
28 ultimate consumer thereof.

24 Respondent next addresses the applicability of R&TC section 23649, subdivision
25 (d)(1)(C) (i.e., to “maintain, repair, measure, or test”), in determining whether the electrical generator
26 assets are qualified property. Respondent first asserts that the backup generator assets do not repair,
27 measure, or test any qualified property and that the question posed is whether the backup generator
28 assets could be said to “maintain” qualified property and, thus, be considered assets that are qualified

1 property as well. Respondent notes that neither R&TC section 23649 nor its accompanying regulations
2 provide a definition of the term “maintain.” Respondent states that the Merriam-Webster Online
3 Dictionary (2010) defines “maintain” as: (1) to keep in an existing state (as of repair, efficiency, or
4 validity) preserve from failure or decline; (2) to sustain against opposition or danger: uphold and defend;
5 (3) to continue or persevere in; (4) to support or provide for; or (5) to affirm in or as if in argument.
6 (Resp. Post-Conference Br., pp. 3-4.)

7 Respondent asserts that, given the active nature of the requirements for qualified property
8 (manufacturing, processing, etc.), the inherently passive nature of a backup generator conflicts with the
9 idea of qualified property as property actively used to produce goods or to maintain property that does
10 so. Respondent contends that the backup generators could be used to operate portions of appellant’s
11 manufacturing property for the sole purpose of preventing potential damage in the case of a power
12 failure, but that the backup generators could not operate the factory. Respondent asserts that the backup
13 generators are functionally the same as spare parts for appellant’s qualified property, as these assets do
14 not keep appellant’s qualified property “in an existing state” or “preserve [the property] from failure or
15 decline” or have any active effect on the qualified property until these assets are put into use (i.e., to
16 provide power). (Resp. Post-Conference Br., p. 4.)

17 Finally, respondent notes that, under Massachusetts law, the purchase of a standby
18 generator used to power clean room equipment in the event of a power outage qualified for a sales tax
19 exemption only because of a specific statutory exemption. Respondent contrasts this with R&TC
20 section 23649 which contains no equivalent provision to qualify appellant’s electrical generator assets
21 for the MIC. (Resp. Post-Conference Br., p. 4.)

22 Appellant’s Contentions

23 Appellant cites the definitions of “manufacturing” and “process” in Regulation 23649-2
24 and asserts that the “manufacturing process,” as defined by the regulations, refers to a period of time or a
25 “window” during which certain activities are performed. Appellant states that it agrees with
26 respondent’s characterization of the manufacturing process of this activity as “the process when the
27 trucks offload milk into milk silos at the manufacturing site. The process is completed when appellant
28 has packaged the final product.” (App. Post-Conference Br., p. 4.)

1 Appellant states that the electrical generator assets stand at the ready during the
2 manufacturing process, in case of a power outage, to empty appellant's cheese-making equipment of
3 milk, partially-processed cheese, and cheese and to avoid serious damage to this equipment. In the
4 event of a power outage, appellant asserts that the equipment in use during steps one through eleven
5 above would be emptied of food product, such that appellant's electrical generator assets primary, and
6 only, use comes during the "manufacturing process" between the introduction of raw materials and the
7 completion of the finished product. Thus, appellant argues that these assets are used in the
8 manufacturing process and are therefore qualified property under R&TC section 23649, subdivision
9 (d)(1)(A). (App. Post-Conference Br., p. 6.)

10 Appellant also asserts that the electrical generator assets qualify for the MIC under
11 R&TC section 23649, subdivision (d)(1)(C), as tangible personal property primarily used "to maintain"
12 other qualified property, like appellant's cheese-making equipment. Appellant states that the parties
13 agree that the relevant definition of the term "maintain" (citing respondent's post-conference brief) is "to
14 keep in an existing state (as of repair, efficiency or validity): preserve from failure or decline."
15 Appellant asserts that the electrical generator assets are only ever used to prevent serious damage to its
16 equipment in case of a power outage, keeping this equipment in an existing state of good repair and
17 preserving it from failure or decline, and, thus, qualifying the property for the MIC under R&TC section
18 23649, subdivision (d)(1)(C). (App. Post-Conference Br., pp. 6-7.)

19 Applicable Law

20 See the summary of Applicable Law in Issue 1 above.

21 STAFF COMMENTS

22 The parties should be prepared to address whether it is necessary for qualified property to
23 "physically participate" in the processing of the raw materials (the milk) into the finished product (the
24 cheese) and, if so, to describe the manner in which such physical participation must occur.

25 Appellant asserts that its electrical generator assets are qualified property under both
26 R&TC section 23649, subdivision (d)(1)(A) (i.e., the manufacturing or processing of property), and
27 under R&TC section 23649, subdivision (d)(1)(C) (i.e., to maintain qualified property). Respondent
28 cites the definition of "maintain" as the act of keeping property in an existing state or preserving [the

1 property] from failure or decline. Here, appellant argues that the electrical generator assets are primarily
2 used to protect the cheese-processing equipment from damage that would be caused by a general power
3 outage. Respondent states that the generator assets could be used to operate portions of appellant's
4 manufacturing property for the sole purpose of preventing potential damage in the case of a power
5 failure, but that the generators would not be capable of operating a plant. Thus, respondent asserts that
6 the generators are functionally equivalent to spare parts for appellant's qualified property. At the
7 hearing, respondent should be prepared to explain whether it agrees that the protection of cheese-
8 processing equipment from damage due to a power outage is, as set forth in the definition above, an act
9 of preserving the equipment from failure or decline. If so, respondent should be prepared to explain
10 whether its position, that this equipment is not "qualified property," is based on the relative infrequency
11 of its use.

12 **Issue 3: Whether appellant has shown that its brick and tile coverings are "qualified property"**
13 **for purposes of R&TC section 23649, and eligible for the MIC.**

14 The issue relating to these assets is whether the assets are tangible personal property and,
15 thus, are qualified property under the MIC statute.¹¹

16 Appellant's brick and tile assets are described as follows. For purposes of plant
17 sanitization and food safety, appellant installed acid brick tiles to cover the concrete floors where
18 manufacturing takes place and ceramic tiles to cover the walls in those locations. The brick and tile
19 assets, along with the associated mortar and epoxy grout, are resistant to the harsh chemicals used in the
20 cleaning of appellant's equipment and are specially designed to be waterproof and free of cracks and
21 crevices. (App. Opening Br., p. 5.)

22 Contentions

23 Appellant's Contentions

24 Appellant contends that its brick and tile assets are tangible personal property under
25 R&TC section 23649, subdivision (d)(1). Appellant asserts that the brick floor coverings and the
26 ceramic wall tiles can be easily removed and replaced or removed or reused in another location.

27
28

¹¹ As mentioned above, respondent concedes that the brick and tile assets are used primarily in a qualified activity. Consequently, that portion of the parties' briefing, relating to this sub-issue, is not reflected in this hearing summary.

1 However, appellant admits that, in practice, the effort to remove grout, and safety concerns about the
2 reuse of old brick and tile assets, normally means that the reuse of the brick and tile assets is unlikely.
3 (App. Opening Br., p. 5.)

4 Appellant asserts that the Board in the *Appeal of Bronco Wine Co. (Bronco Wine)*, 2002-
5 SBE-006, Nov. 13, 2002, concluded that the definition of “tangible personal property” as used in R&TC
6 section 23649, subdivision (d), incorporated federal statutes, regulations, and case law into California
7 tax law. Appellant argues that the leading case on characterizing the meaning of “tangible personal
8 property” is *Whiteco Industries, Inc. et al. v. Commissioner (Whiteco)* (1975) 65 T.C. 664, in which the
9 Tax Court set forth a six-factor test.¹² Appellant cites *Bronco Wine* which provides that “the guiding
10 principle when applying the six-factor *Whiteco* analysis should be whether the property at issue can
11 reasonably be moved and placed back into productive use without damaging the property” and that this
12 principle “avoids the need for respondent to examine a taxpayer’s subjective intent with regard to the
13 future use of the property.” (*Bronco Wine* at p. 8.)

14 Appellant also argues that the Tax Court in *Hospital Corp. of America & Subsidiaries*
15 (*Hospital Corp.*), (1997) 109 T.C. 21, applied the *Whiteco* test and concluded that vinyl floor tiles used
16 in a hospital, attached to a concrete floor, and discarded upon removal, were tangible personal property
17 and not structural components of the building. (App. Opening Br., p. 16.) Appellant asserts that the
18 similarities between appellant’s brick and tile assets and the floor tiles in *Hospital Corp.* are striking as
19 both situations involve the use of temporary floor coverings affixed to permanent concrete floors for
20 sanitation purposes. (App. Opening Br., p. 17.)

21 Appellant next asserts that appellant’s brick and tile assets meet the six-factor *Whiteco*
22 test as follows: (1) the bricks and tiles are capable of being moved; (2) the bricks and tiles were not
23 designed or constructed to remain in place permanently but, instead, were designed to be removable and
24

25 ¹² The Tax Court in *Whiteco* put forth the following six-factor test:

- 26 (1) is the property capable of being moved, and has it in fact been moved?;
27 (2) is the property designed or constructed to remain permanently in place?;
28 (3) are there circumstances which tend to show the expected or intended length of affixation? (i.e., are there circumstances
which show that the property may or will have to be moved?);
(4) how substantial is the job of removing the property and how time-consuming is it? (i.e., is the property readily movable?);
(5) how much damage will the property sustain upon its removal?; and
(6) what is the manner of affixation of the property to the land?

1 replaceable; (3) there are circumstances that tend to show that the property may or will have to be
2 moved; (4) although the removal of the bricks and tiles would require a considerable amount of work,
3 that effort would be no more than that required of other property determined to be tangible personal
4 property; (5) the bricks and tiles would not sustain damage upon removal, but manual effort would be
5 required to remove grout and safety concerns would discourage the reuse of the bricks and tiles; and (6)
6 the bricks and tiles are not affixed to the floor permanently and can be removed and replaced if
7 necessary. (App. Opening Br., pp. 17-19.)

8 As to the fifth factor (i.e., the damage sustained by the property upon removal), appellant
9 points out that the Board in *Bronco Wine* found that the winery's 215,000 gallon tanks were found to be
10 tangible personal property despite the fact that the tanks had to be cut into sections to be moved. (App.
11 Opening Br., p. 18, fn. 25.) Appellant therefore contends that, because the brick and tile assets satisfy
12 the *Whiteco* test, these assets are tangible personal property. Therefore, as tangible personal property
13 and for the reasons stated, appellant concludes that the brick and tile assets are qualified property for
14 purposes of R&TC section 23649, subdivision (d), and are eligible for the MIC. (App. Opening Br.,
15 pp. 18-19.)

16 In its reply brief, appellant provides a declaration from its vice president who is
17 responsible for appellant's engineering and construction matters. In that declaration, the vice president
18 asserts that appellant's bricks and tiles can be easily removed and replaced, are not installed to be
19 permanently attached to the floors and walls, and could be removed and reused in another location if
20 necessary (but that such reuse was unlikely). (App. Reply Br., p. 8; App. Reply Br., Exhibit A.) In
21 addition, appellant argues that vinyl floor tiles (*Hospital Corp.*), wall-to-wall carpeting, shelves, 55-foot
22 support poles, and neon signs (*Whiteco*) have all been found to be tangible personal property and
23 theoretically could be reused. Appellant reiterates that the *Whiteco* test is not designed to "examine a
24 taxpayer's subjective intent with respect to the future use of the property." Instead, appellant asserts that
25 case law supports a determination that the brick and tile assets are tangible personal property under
26 R&TC section 23649, subdivision (d)(1), and qualify for the MIC. (App. Reply Br., pp. 10-11.)

27 In its supplemental brief, appellant disputes respondent's allegation that some of its assets
28 may have been expensed instead of capitalized. Appellant asserts that all of the disputed assets were

1 capitalized as fixed assets and depreciated for financial statement and income tax purposes. (App. Supp.
2 Br., p. 2; Exhibit D.)

3 Appellant also disputes respondent's assertion that the Board's decision in *Bronco Wine*
4 supercedes the federal investment tax credit cases and contends that the claim is not supported by the
5 applicable law, the regulations, or by *Bronco Wine* itself. (App. Supp. Br., p. 9.) Appellant asserts that
6 R&TC section 23649, subdivision (d)(1), specifically references IRC section 1245 as the basis for
7 defining the term "tangible personal property" and that the Board in *Bronco Wine* applied the test from
8 *Whiteco*, a federal investment tax credit case. Appellant argues that, contrary to respondent's assertion
9 (made without any supporting citation), federal case law was incorporated by *Bronco Wine*. (App.
10 Supp. Br., pp. 9-10.) Finally, appellant argues that, similar to the taxpayer with the 215,000 gallon tanks
11 in *Bronco Wine*, appellant does not intend to move the brick and tile assets after installation.
12 Nevertheless, appellant asserts that the Board in *Bronco Wine* found that the 215,000 gallon tanks were
13 tangible personal property. Consequently, appellant contends that the brick and tile assets could be
14 removed and reused, if necessary, such that these assets should also be considered tangible personal
15 property. (App. Supp. Br., pp. 11-12.)

16 Respondent's Contentions

17 Respondent contends that tangible personal property eligible for the MIC is generally
18 considered to be any tangible personal property except land and improvements, such as buildings and
19 other inherently permanent structures. According to respondent, the determination of whether property
20 is an inherently permanent structure is made in accordance with IRC section 1245(a) which describes an
21 "inherently permanent structure" as one which is affixed permanently and is incapable of being moved
22 without significant damage.¹³ Respondent explains that, in *Bronco Wine*, the Board concluded that the
23 taxpayer's holding tanks were qualified property, but that the concrete foundations were not. (Resp.
24 Opening Br., p. 6.)

26
27 ¹³ The Appeals Division notes that IRC section 1245(a)(3)(B) describes Section 1245 property, in part, as "not including a
28 building or its structural components." Treasury Regulation section 1.1245-3(b)(1) defines the term "personal property" by
referencing Treasury Regulation section 1.48-1(c). And, finally, Treasury Regulation section 1.48-1(c) provides, in part, that
the term "tangible personal property" means "any tangible personal property except land and improvements thereto, such as
buildings or other inherently permanent structures (including items which are structural components of such buildings or
structures.)"

1 Respondent asserts that the issue of “inherently permanent structures” as “qualified
2 property” was at issue in *Bronco Wine* and the Board concluded that the six factors in *Whiteco* held
3 significant weight in this analysis. However, respondent contends that the six factors from *Whiteco*
4 were not decisive in determining whether property is considered an inherently permanent structure.
5 Instead, respondent asserts that the Board concluded in *Bronco Wine* that the question is whether the
6 property at issue could be reasonably moved and placed back into productive use without damaging the
7 property. (Resp. Opening Br., pp. 6-7.)

8 Regarding appellant’s brick and tile assets, respondent contends that the assets appear to
9 be constructed to remain permanently attached to the floor and walls to which the assets are attached and
10 do not appear to be readily movable or removable without sustaining damage when removed or readily
11 usable in another location when moved. (Resp. Opening Br., p. 7.) Respondent contends that the issue
12 is not whether the brick and tile assets are removable and replaceable but whether the property can
13 reasonably be moved and placed back into productive use without damaging the property. Respondent
14 asserts that each brick and tile, once removed, cannot be placed back into productive use. Respondent
15 concludes that, because the brick and tile assets appear to be incapable of being moved without
16 considerable effort and damage and have not been demonstrated to have been relocated, these assets are
17 inherently permanent property and therefore are not qualified property. (Resp. Opening Br., p. 8.)
18 Respondent asserts that appellant does not dispute that reuse of the brick and tile assets are unlikely.
19 (Resp. Reply Br., p. 5; App. Reply Br., Exhibit A, p. 2.)

20 Respondent also asserts that appellant’s reliance on the federal investment tax credit and
21 related case law is inappropriate as (1) the Board’s decision in *Bronco Wine* supercedes these cases for
22 purposes of the MIC, as the Board analyzed what comprises “inherently personal property” and the
23 *Whiteco* factors in that decision, and (2) unlike the MIC, the federal investment tax credit does not
24 require capitalizing the cost of qualifying tangible personal property in order to attain the credit. (Resp.
25 Reply Br., pp. 4-5.) Regarding this second requirement, respondent adds that R&TC section 23649,
26 subdivision (b)(1)(C), restricts the credit to the “amount properly chargeable to the capital account of the
27 qualified taxpayer.” Accordingly, respondent asserts that appellant must show that it did not expense its
28 purchase of the brick and tile assets for such assets to qualify for the MIC. (Resp. Reply Br., p. 5.)

1 Post-Conference Briefing

2 The following questions were posed to the parties:

3 Respondent

- 4 (1) Regarding the brick/tile assets, please confirm respondent’s position that: (1) it does not
5 dispute that the assets have a qualifying use and are used in the manufacturing process, but
6 (2) that the assets are not tangible personal property.

7 Appellant

- 8 (1) Please describe the manufacturing process. The description should include and specify at
9 which stages of manufacturing the claimed assets are used (and how that equipment is used
10 in the manufacturing process), including when the use of each piece of equipment begins
11 and when the use of each piece of equipment ends.
12 (2) Regarding the brick/tile assets, appellant states that the test is not whether the bricks/tiles are
13 *actually* reused, but that the bricks/tiles *could be* reused. What is appellant’s authority for
14 this standard?

15 Respondent’s Contentions

16 Respondent confirmed that it does not contest that the brick and tile assets have a
17 qualifying use.¹⁴ However, respondent asserts that the brick and tile assets are not qualified property
18 because these assets are not tangible personal property. Instead, respondent contends that the brick and
19 tile assets are “inherently permanent property” by virtue of the essentially permanent affixing of the
20 assets to the factory building. Respondent argues, relying upon *Bronco Wine*, that the permanence of
21 the affixation and the inherently permanent nature of the brick and tile assets are evidenced by the fact
22 that the assets cannot be reasonably removed and reused. Respondent notes that, although appellant
23 asserts that the brick and tile assets can be removed and reused, appellant admits that these assets are not
24 reused but destroyed upon removal and replaced with new bricks and tiles.¹⁵ (Resp. Post-Conference

25 _____
26 ¹⁴ In other words, as mentioned above, respondent does not dispute that the brick and tile assets are used primarily in a
27 qualified activity.

28 ¹⁵ Respondent requests that appellant should demonstrate to the Board whether it expenses or capitalizes the costs associated
with the brick and tile assets.

1 Br., pp. 4-5.)

2 Appellant's Contentions

3 Appellant cites the definitions of "manufacturing" and "process" in Regulation 23649-2
4 and asserts that the "manufacturing process," as defined by the regulations, refers to a period of time or a
5 "window" during which certain activities are performed. Appellant states that it agrees with
6 respondent's characterization of the manufacturing process of this activity as "the process when the
7 trucks offload milk into milk silos at the manufacturing site. The process is completed when appellant
8 has packaged the final product." (App. Post-Conference Br., p. 4.)

9 Appellant states that the brick and tile assets have a sanitary function, not a structural
10 function, and, thus, enable the preservation of a sanitary environment indispensable to the manufacture
11 of food products. Appellant states that bricks and tiles are used so that, if one becomes cracked or
12 chipped, the particular brick or tile can be removed and replaced without replacing the floor or wall
13 itself. Appellant further states that bricks and tiles are used throughout the procedures summarized in
14 steps two through eleven of the manufacturing process above,¹⁶ surrounding the cheese-making
15 equipment in each of these steps and enabling the preservation of a sanitary environment. (App. Post-
16 Conference Br., pp. 5-6.)

17 Regarding respondent's inquiry as to whether the costs associated with the purchase of
18 brick and tile assets were capitalized or expensed, appellant reiterates that such costs were capitalized,
19 pointing out the evidence submitted as Exhibit D of its supplemental brief. Appellant argues that
20 respondent should have raised this issue in its opening brief, citing Rules for Tax Appeals Regulation
21 5431, subdivision (c)(2).¹⁷ (App. Post-Conference Br., p. 6, fn. 4.)

22 As to whether the bricks and tiles must actually be reused, appellant argues that there is
23 no requirement that a category of assets actually be reused in order to qualify as "tangible personal
24 property" for purposes of the MIC. Appellant states that R&TC section 23649, subdivision (d)(1),
25

26 _____
27 ¹⁶ Appellant notes that bricks and tiles are not located in the area where milk is received via trucks and pumped into silos
(step 1 of the manufacturing process, as summarized on page 4 above).

28 ¹⁷ Regulation 5431, subdivision (c)(2), provides in part that "Respondent's Reply Brief, if filed, may only address points of
disagreement with the Appellant's Reply Brief."

1 defines “tangible personal property” by referencing the federal definition of that term as found in IRC
2 section 1245 and that the Board, in applying the standard for tangible personal property in *Bronco Wine*,
3 *supra*, cited the U.S. Tax Court in *Whiteco Industries, supra*. Appellant further states that the Board in
4 *Bronco Wine* concluded that, because of the reference to IRC section 1245, it was appropriate to
5 incorporate a substantial body of federal law in defining the term “tangible personal property.” Thus,
6 appellant argues that respondent’s position (i.e., that *Bronco Wine* superceded the federal investment tax
7 credit cases) is incorrect and that federal case law was expressly incorporated into California law by
8 *Bronco Wine*. (App. Post-Conference Br., pp. 8-9.)

9 Appellant argues that *Bronco Wine* makes clear that there is no requirement of an actual
10 reuse of assets in order to qualify as tangible personal property. Appellant asserts that the Board in
11 *Bronco Wine* put forth an objective standard regarding reuse (i.e., an analysis of whether property can
12 reasonably be reused), such that the analysis does not require that property actually be reused. Appellant
13 further asserts that the Board found that this type of analysis avoids an examination of a taxpayer’s
14 subjective intent regarding the future use of property (App. Post-Conference Br., pp. 9-10.)

15 Appellant next argues that *Hospital Corp., supra*, confirms this analysis as the Tax Court
16 found that tiles adhered to a hospital floor, removable with a mechanical scraper, and discarded after
17 removal, were tangible personal property. Appellant contends that this case refutes the notion that, to
18 qualify as tangible personal property, an asset must actually be reused and that the case was incorporated
19 into California law by *Bronco Wine*, as discussed above. Appellant asserts that its brick and tile assets
20 are indistinguishable from the floor tiles in *Hospital Corp.* and constitute tangible personal property as
21 both sets of assets are (1) temporary floor coverings affixed to permanent concrete floors for sanitation
22 purposes, (2) designed to be removable and replaceable, and (3) reusable in principle but, in practice, not
23 normally reused. (App. Post-Conference Br., p. 10.)

24 Applicable Law

25 As to whether the assets are tangible personal property, Regulation 23649-5, subdivision
26 (b)(1), defines the term “tangible personal property” as follows:

27 “. . . any tangible property except land and improvements thereto, such as buildings or
28 other inherently permanent structures (including items which are structural components
of such buildings or structures). Tangible personal property includes all property (other
than structural components) which is contained in or attached to a building. Thus, for

1 example, production machinery, printing presses, and testing equipment which is
2 contained in or attached to a building is tangible personal property. Furthermore, all
3 property which is in the nature of machinery (other than structural components of a
4 building or other inherently permanent structures) shall be considered tangible personal
5 property even though located outside a building. The determination of whether property
6 will be treated as an inherently permanent structure shall be made under Internal Revenue
7 Code Section 1245(a), so that generally property will be treated as an inherently
8 permanent structure (and thus not tangible personal property) if the property is either
9 intended to be or is in fact affixed permanently, and is either incapable of being moved
10 or, if movable, would suffer a significant degree of damage upon its removal. . . .”

7 In addition, Regulation 23649-5, subdivision (b)(2), further defines “tangible
8 personal property” as follows:

9 Section 1245(a) Property. Property must be defined in Internal Revenue Code Section
10 1245(a). However, since property must also be tangible personal property under
11 subsection (b)(1) of this regulation, then, except for any “off-the-shelf” computer
12 software upon which California sales or use tax has been paid and except for property
13 described in subsection (f) of this regulation, only personal property described in Internal
14 Revenue Code Section 1245(a)(3)(A) will be treated as qualified property for purposes of
15 the MIC. Except as provided in the previous sentence, other tangible property that is
16 described in Internal Revenue Code Sections 1245(a)(3)(B) through (F) is not “personal”
17 property and is thus not qualified property under Revenue and Taxation Code Section
18 23649.

15 Treasury Regulation section 1.1245-3 provides a definition of IRC section 1245 property.
16 Specifically, Treasury Regulation section 1.1245-3(b)(1) defines the term “personal property” by
17 referencing Treasury Regulation section 1.48-1(c). Treasury Regulation section 1.48-1(c) provides a
18 definition of the term “tangible personal property” and Treasury Regulation section 1.48-1(e)(2)
19 provides a definition of the term “structural components. Treasury Regulation section 1.48-1(c) defines
20 tangible personal property, in part, as:

21 Definition of tangible personal property. If property is tangible personal property it may
22 qualify as section 38 property irrespective of whether it is used as an integral part of an
23 activity (or constitutes a research or storage facility used in connection with such activity)
24 specified in paragraph (a) of this section. Local law shall not be controlling for purposes
25 of determining whether property is or is not “tangible” or “personal”. . . . For purposes of
26 this section, the term “tangible personal property” means any tangible property except
27 land and improvements thereto, such as buildings or other inherently permanent
28 structures (including items which are structural components of such buildings or
structures). Thus, buildings, swimming pools, paved parking areas, wharves and docks,
bridges, and fences are not tangible personal property. Tangible personal property
includes all property (other than structural components) which is contained in or attached
to a building. Thus, such property as production machinery, printing presses,
transportation and office equipment, refrigerators, grocery counters, testing equipment,
display racks and shelves, and neon and other signs, which is contained in or attached to a
building constitutes tangible personal property for purposes of the credit allowed by
section 38. Further, all property which is in the nature of machinery (other than structural
components of a building or other inherently permanent structure) shall be considered

1 tangible personal property even though located outside a building. Thus, for example, a
2 gasoline pump, hydraulic car lift, or automatic vending machine, although annexed to the
ground, shall be considered tangible personal property. (Underlines added.)

3 Treasury Regulation section 1.48-1(e)(2)¹⁸ defines the term “structural components,” in
4 part, as:

5 The term “structural components” includes such parts of a building as walls, partitions,
6 floors, and ceilings, as well as any permanent coverings therefor such as paneling or
7 tiling; windows and doors; all components (whether in, on, or adjacent to the building) of
8 a central air conditioning or heating system, including motors, compressors, pipes and
9 ducts; plumbing and plumbing fixtures, such as sinks and bathtubs; electric wiring and
10 lighting fixtures; chimneys; stairs, escalators, and elevators, including all components
11 thereof; sprinkler systems; fire escapes; and other components relating to the operation or
12 maintenance of a building. However, the term “structural components” does not include
13 machinery the sole justification for the installation of which is the fact that such
14 machinery is required to meet temperature or humidity requirements which are essential
15 for the operation of other machinery or the processing of materials or foodstuffs.
16 Machinery may meet the “sole justification” test provided by the preceding sentence even
17 though it incidentally provides for the comfort of employees, or serves, to an
18 insubstantial degree, areas where such temperature or humidity requirements are not
19 essential. For example, an air conditioning and humidification system installed in a
20 textile plant in order to maintain the temperature or humidity within a narrow optimum
21 range which is critical in processing particular types of yarn or cloth is not included
22 within the term “structural components” (Underlining added)

23 R&TC section 23649, subdivision (e)(5), defines the term “primarily used” as “tangible
24 personal property used 50 percent or more of the time in an activity described in subdivision (d).” More
25 specifically, Regulation 23649-2, subdivision (k), defines the term “primarily used” as meaning:

26 . . . that property is used 50 percent or more of the time in any qualified activity. For
27 purposes of the preceding sentence, the term “time” shall mean the total number of hours
28 that the property is actually in use during the 12-month period immediately following the
date the property is placed in service in this state. For example, if an item of property is
used by a qualified taxpayer for a total of 100 hours for all uses during the 12-month
period immediately following the date the property is placed in service in this state, then
“primarily” used in a qualified activity means at least 50 hours of the property's use is in
a qualified activity.

29 In *Bronco Wine*, the Board was presented with the issue of determining whether a
30 winery's 215,000 gallon tanks, and the concrete foundations for these tanks, constituted tangible
31 personal property and, thus, qualified property for purposes of the MIC. The Board concluded that the
32 215,000 gallon tanks, but not the concrete foundations, were tangible personal property. (Prior to the
Board's decision, the Franchise Tax Board had concluded that the 215,000 gallon tanks were inherently

¹⁸ Subdivision (e) of the regulation provides the definition of the terms “building” and “structural components.”

1 permanent structures and, thus, not tangible personal property.) Specifically, the Board found that:

2 . . . we agree with the statutory interpretation offered by respondent and the definition of
3 “tangible personal property” set forth in its regulation [Regulation 23649-5]. Initially, we
4 recognize that respondent’s regulation essentially sets forth a definition of “tangible
5 personal property” specially tailored to the purposes of the MIC. . . . With this
6 consideration in mind, we conclude the reference in section 23649, subdivision (d), to
7 IRC section 1245(a) necessarily incorporates into the MIC a substantial body of federal
8 law defining the term “tangible personal property.” Specifically, the statutory reference
9 to IRC section 1245(a) incorporates Treasury Regulation section 1.1245-3(b), [footnote
10 omitted] which in turn incorporates the definition of “tangible personal property” from
11 Treasury Regulation section 1.48-1(c) [footnote omitted] relating to the definition of IRC
12 “section 38 property” for purposes of the now-expired federal investment tax credit. . . .

13 * * *

14 We agree respondent’s reliance on and incorporation of the relevant Treasury
15 Regulations necessarily includes the relevant federal case law interpreting and applying
16 those regulations. Thus, we approve of respondent’s reliance on the *Whiteco* six-factor
17 analysis guiding the determination of whether property is tangible personal property or an
18 inherently permanent structure. We disagree, however, with the result respondent
19 reaches after its application of the *Whiteco* factors in this appeal, and offer guidance to
20 respondent with respect to future application of the analysis. Upon review of the six
21 factors set forth and applied in *Whiteco*, we conclude the guiding principle when applying
22 the six factor *Whiteco* analysis should be whether the property at issue can reasonably be
23 moved and placed back into productive use without damaging the property. We offer
24 that applying this principle avoids the need for respondent to examine a taxpayer’s
25 subjective intent with regard to the future use of the property at the time the property was
26 placed into service and allows taxpayers to make decisions regarding manufacturing
27 property motivated by business needs, rather than tax considerations. We believe this
28 approach will more accurately carry out the intent of the legislature in enacting the MIC
than the strict application of the *Whiteco* analysis offered by respondent. We also believe
this approach, in conjunction with the *Whiteco* analysis, considers the fact that the term
“inherently permanent structure” does not describe a clearly recognizable or defined class
of property. (*Whiteco Industries, Inc., et al. v. Commissioner, supra*, 65 T.C. at p. 671.)

19 (*Bronco Wine*, pp. 5-6, 8; underlines added; footnotes deleted.) It is significant to note that the Board in
20 *Bronco Wine* initially concluded that the winery’s tanks were not machines or machinery such that it
21 was appropriate to apply the six-factor *Whiteco* analysis to determine whether the tanks were inherently
22 permanent structures or tangible personal property.

23 In applying the *Whiteco* factors, the Board made the following, amongst other,
24 conclusions, none of which the Board found to be exclusively decisive in reaching a determination.
25 First, the tanks had not, but could, be moved. Second, tanks were designed and constructed to remain
26 permanently in place. Next, the cost estimates for moving the tanks indicate that such an undertaking
27 might be more economical than purchasing and constructing new tanks. And, finally, the facts that the
28 tanks rested on concrete foundations and were bolted to metal strips imbedded in the foundation did not

1 mean that the tanks were affixed to the ground. Nevertheless, the Board concluded that affixation to
2 land did not per se exclude the property from qualifying as tangible personal property.

3 The Tax Court in *Whiteco*¹⁹ set forth six-factors to guide the determination of whether
4 specific property is tangible personal property, rather than an inherently permanent structure, under
5 Treasury Regulation section 1.48-1(c) for purposes of the federal investment tax credit. Specifically, the
6 court sought to determine whether or not outdoor billboards constituted tangible personal property, or
7 inherently permanent structures. The court set forth the following six factors culled from other federal
8 cases to guide its determination:

9 (1) is the property capable of being moved, and has it in fact been moved?;

10 (2) is the property designed or constructed to remain permanently in place?;

11 (3) are there circumstances which tend to show the expected or intended length of affixation?

12 (i.e., are there circumstances which show that the property may or will have to be moved?);

13 (4) how substantial is the job of removing the property and how time-consuming is it? (i.e., is the
14 property readily movable?);

15 (5) how much damage will the property sustain upon its removal?; and

16 (6) what is the manner of affixation of the property to the land?

17 (*Whiteco* at pp. 672-673.)

18 STAFF COMMENTS

19 In *Bronco Wine*, the Board held that the definition of “tangible personal property as set
20 forth in Regulation 23649-5 is controlling, after reviewing both the subdivision (b)(1) and (b)(2)
21 definitions of the term (which are both detailed above) in the regulation. Regulation 23649-5,
22 subdivision (b)(1), provides, in part, that “all property which is in the nature of machinery (other than
23 structural components of a building or other inherently permanent structures) shall be considered
24 tangible personal property . . . The determination of whether property will be treated as an inherently
25 permanent structure shall be made under Internal Revenue Code Section 1245(a), so that generally
26 property will be treated as an inherently permanent structure (and thus not tangible personal property) if
27

28 ¹⁹ In *Whiteco*, the Tax Court was faced with determining whether billboards were tangible personal property, as opposed to inherently permanent structures, for purposes of the federal investment tax credit.

1 the property is either intended to be or is in fact affixed permanently, and is either incapable of being
2 moved or, if movable, would suffer a significant degree of damage upon its removal.”

3 In *Bronco Wine*, the Board held that, for purposes of the MIC, it was appropriate to
4 incorporate a substantial body of federal law when defining the term “tangible personal property.”
5 Consistent with the definition of “tangible personal property” in Regulation 23649-5, subdivision (b)(1),
6 Treasury Regulation section 1.48-1(c) provides that “tangible personal property” does not include land
7 and improvements, such as buildings and inherently permanent structures, including items which are
8 structural components. Consequently, the Appeals Division believes that it is appropriate to look to the
9 definition of “structural components,” in subdivision (e)(2) of Treasury Regulation section 1.48-1 to
10 determine which types of property are *not considered* “tangible personal property” under federal law. In
11 this regard, Treasury Regulation 1.48-1(e)(2) defines the term “structural components” to include “such
12 parts of a building as walls, partitions, floors, and ceilings, as well as any permanent coverings therefor
13 such as paneling or tiling; windows and doors; . . .” At the hearing, the parties should be prepared to
14 discuss whether the foregoing definition applies to the brick and tile assets for purposes of the qualifying
15 property determination.

16 Finally, the Board in *Bronco Wine* declared that the application of the six-factor *Whiteco*
17 analysis requires a determination of whether the property at issue can reasonably be moved and placed
18 back into productive use without damaging the property. The Board concluded that this approach
19 avoided the need for the Franchise Tax Board to examine a taxpayer’s subjective intent, with regard to
20 the future use of the property at the time the property was placed into service, and allowed taxpayers to
21 make decisions regarding manufacturing property motivated by business needs, rather than tax
22 considerations.

23 Here, appellant states that it does not intend to move the bricks and tiles after installation.
24 However, appellant asserts that the bricks and tiles can be easily removed and replaced or removed or
25 reused in another location but states that, in practice, the effort to remove grout, and safety concerns
26 about the reuse of old brick and tile assets, normally means that the reuse of the brick and tile assets is
27 unlikely. Additionally, from the facts presented it appears that bricks and tiles are only removed and
28 replaced if one becomes cracked or chipped. At the hearing, the parties should be prepared to discuss

1 whether the evidence shows that foregoing factors have been met.

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