2002-SBE-006

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of	)	
	)	No. 138562
Bronco Wine Company	)	
	)	

Representing the Parties:

For Appellant:	John M. Youngquist, Esq. Chris Micheli, Esq.
For Respondent:	Geoffrey S. Way, Tax Counsel III
Counsel for Board of Equalization:	Reed Schreiter, Tax Counsel

O P I N I O N

This appeal is made pursuant to section 19324, subdivision (a),[1] of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the claim of Bronco Wine

[1] Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the year in issue.

Company for refund of franchise tax in the amount of $35,362 for the year ended September 30, 1996. The issue presented by this appeal is whether appellant's 215,000 gallon tanks and all the concrete tank foundations utilized in the manufacture of wine constitute "tangible personal property," and thus constitute qualified property pursuant to section 23649, subdivision (d).[2]

Appellant operates a large winemaking facility in Ceres, California. In 1996, appellant purchased 71 used wine tanks with capacities of 5,000, 10,000, and 20,000 gallons. The tanks, by means of metal legs attached to the tanks, stand on poured-in-place concrete slabs (foundations). A system of stairways and overhead catwalks connect the tanks and provide overhead access to the tanks for sampling and gauging the wine. In 1996, appellant also constructed two 215,000 gallon tanks at its facility. Each 215,000 gallon tank rests on a poured-in-place, circular, raised concrete foundation with a concave surface containing a trough for evacuating lees[3] from the contents of the tank. Sheets of formed stainless steel overlay the concrete foundation and comprise the actual tank bottom. The upper portions of the tank consist of stainless steel sections transported to the facility, welded together, and lowered by gantry crane onto the stainless steel tank bottom/concrete foundation. The upper portion is then welded to the stainless steel tank bottom to form the completed tank. The completed tank is bolted and welded to metal footings imbedded in the concrete foundation.

Appellant filed an amended tax return for the year ended September 30, 1996. Respondent audited appellant's amended return allowing appellant's claim for refund with respect to adjustments unrelated to the Manufacturers' Investment Credit (MIC), but disallowed all claimed costs under the MIC related to the tanks on the basis that the tanks were inherently permanent structures and thus not tangible personal property.[4] On protest, however, respondent allowed costs related to the 5,000, 10,000, and 20,000 gallon tanks and above-ground improvements (e.g., stairways and catwalks), determining the smaller tanks were tangible personal property rather than inherently permanent structures. Respondent continued, however, to disallow the costs associated with the

(..continued)

[2] Section 17053.49, subdivision (d), sets forth similar provisions in the Personal Income Tax Law, including an identical definition of "qualified property." Our discussion thus also appears to apply to those provisions.

[3] The term "lees," or "yeast lees," refers to the sediment that settles to the bottom of a fermenting tank through the force of gravity. Lees consist of suspended yeast and grape pulp fragments present in the fermentation process.

[4] Respondent agreed appellant engaged in the manufacture of wine as described in the Standard Industrial Classification (SIC) Manual published by the United States Office of Management and Budget, 1987 edition, and thus was a qualified taxpayer.

215,000 gallon tanks and the concrete foundations for all the tanks (including the 5,000, 10,000, and 20,000 gallon tanks). Appellant timely appealed to this Board.

The MIC provides an income tax credit to any qualified taxpayer for specified qualified costs paid or incurred on or after January 1, 1994, for qualified property placed into service in this state. (Rev. & Tax. Code, § 23649, subd. (a)(1); Cal. Code Regs., tit. 18, § 23649-1, subd. (a).) At the heart of this appeal lies section 23649, subdivision (d), which states, "[Q]ualified property means . . . (1) Tangible personal property that is defined in Section 1245(a) of the Internal Revenue Code . . . that is primarily used . . . (A) [f]or the manufacturing, processing, refining, fabricating, or recycling of property."[5] To elucidate this provision, respondent promulgated California Code of Regulations, title 18 (Regulation), section 23649-5, subdivision (b)(1), which defines tangible personal property as follows:

> "[T]he term 'tangible personal property' means any tangible 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). Tangible personal property includes all property (other than structural components) which is contained in or attached to a building. Thus, for example, production machinery, printing presses, and testing equipment which is contained in or attached to a building is tangible personal property. Furthermore, all property which is in the nature of machinery (other than structural components of a building or other inherently permanent structures) shall be considered tangible personal property even though located outside a building. The determination of whether property will be treated as an inherently permanent structure shall be made under Internal Revenue Code section 1245(a), so that generally property will be treated as an inherently permanent structure (and thus not tangible personal property) if the property is either intended to be or is in fact affixed permanently, and is either incapable of being moved or, if movable, would suffer a significant degree of damage upon its removal."

Regulation section 23649-5, subdivision (b)(1), also states that local law is not controlling for purposes of determining whether or not property is tangible or personal. Regulation section 23649-5, subdivision (b)(2), further defines tangible personal property as follows:

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[5] As pointed out by respondent, this provision actually sets forth two requirements for qualified property: (1) The property must be tangible personal property that is defined in Internal Revenue Code (IRC) section 1245(a) (the element at issue in this appeal); and (2) the property must be used 50 percent or more in one of the specified activities, such as manufacturing. (Rev. & Tax. Code, § 23649, subds. (d)(1) & (e)(5).)

> "Property must be defined in Internal Revenue Code section 1245(a). However, since property must also be tangible personal property under subdivision (b)(1) of this regulation, then, . . . only personal property described in Internal Revenue Code section 1245(a)(3)(A) will be treated as qualified property for purposes of the MIC. [Except as otherwise provided], other tangible property that is described in Internal Revenue Code section 1245(a)(3)(B) through (F)[6] is not 'personal' property and is thus not qualified property under Revenue and Taxation Code section 23649."

Appellant contends its 215,000 gallon tanks and all the tank foundations constitute tangible personal property defined in IRC section 1245(a), and thus constitute qualified property for purposes of the MIC. Appellant argues respondent's regulations construe the definition of qualified property too narrowly, and thus improperly limit tangible personal property to property described in IRC section 1245(a)(3)(A), to the exclusion of property described in IRC section 1245(a)(3)(B) through (F). Appellant also argues the allowance of its claimed costs for the 215,000 gallon tanks and

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[6] IRC section 1245(a)(3) defines "Section 1245 property" as follows:

> "[A]ny property which is or has been property of a character subject to the allowance for depreciation provided in section 167 and is either—
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> (A) personal property,
>
> (B) other property (not including a building or its structural components) but only if such other property is tangible and has an adjusted basis in which there are reflected adjustments described in paragraph (2) for a period in which such property (or other property) –
>
> (i) was used as an integral part of manufacturing, production, or extraction or of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services,
>
> (ii) constituted a research facility used in connection with any of the activities referred to in clause (i), or
>
> (iii) constituted a facility used in connection with any of the activities referred to in clause (i) for the bulk storage of fungible commodities (including commodities in a liquid or gaseous state),
>
> (C) so much of any real property (other than any property described in subparagraph (B)) which has an adjusted basis in which there are reflected adjustments for amortization under section 169, 179, 179A, 185, 188 (as in effect before its repeal by the Revenue Reconciliation Act of 1990), 190, 193, or 194[,]
>
> (D) a single purpose agricultural or horticultural structure (as defined in section 168(i)(13)),
>
> (E) a storage facility (not including a building or its structural components) used in connection with the distribution of petroleum or any primary product of petroleum, or
>
> (F) any railroad grading or tunnel bore (as defined in section 168(e)(4))."

the tank foundations coincides with the legislative intent regarding the MIC. Specifically, appellant argues respondent's narrow construction of qualified property violates our statement in the *Appeal of Save Mart Supermarkets & Subsidiary* (2002-SBE-002), decided February 6, 2002, directing a liberal construction of the MIC in favor of taxpayers to effectuate the purposes of the legislation. In the same vein, appellant opines the legislative history of section 23649 indicates the legislature's intent to limit the MIC only to depreciable property used in manufacturing in order to exclude supplies and consumables, not to restrict the MIC to undefined personal property, which excludes tangible property (under IRC section 1245(a)(3)(B)). In addition, appellant contends the reference to IRC section 1245(a) adds nothing to the definition of "tangible personal property" if the definition of qualified property is limited only to "personal property" in IRC section 1245(a)(3)(A).

After due consideration of appellant's arguments, we agree with the statutory interpretation offered by respondent and the definition of "tangible personal property" set forth in its regulation. Initially, we recognize that respondent's regulation essentially sets forth a definition of "tangible personal property" specially tailored to the purposes of the MIC. (See *Weirick v. Commissioner* (1974) 62 T.C. 446, 451.) With this consideration in mind, we conclude the reference in section 23649, subdivision (d), to IRC section 1245(a) necessarily incorporates into the MIC a substantial body of federal law defining the term "tangible personal property." Specifically, the statutory reference to IRC section 1245(a) incorporates Treasury Regulation section 1.1245-3(b),[7] which in turn incorporates the definition of "tangible personal property" from Treasury Regulation section 1.48-1(c)[8]

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[7] Pursuant to section 23051.5, subdivision (d), the federal Treasury Regulations accompanying sections of the IRC are applicable to the extent they do not conflict with the Revenue and Taxation Code or regulations issued by respondent.

[8] Treasury Regulation section 1.48-1(c) defines tangible personal property as follows:

> "[T]he 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). 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 [IRC] 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 tangible personal property even though located outside a building. Thus, for example, a gasoline pump, hydraulic car lift, or automatic vending machine, although annexed to the ground, shall be considered tangible personal property."

relating to the definition of IRC "section 38 property" for purposes of the now-expired federal investment tax credit. Although the reference in section 23649, subdivision (d), to IRC section 1245(a) could be read to include IRC section 1245(a)(3)(B) through (F) in addition to IRC section 1245(a)(3)(A), we believe the use of the phrase "tangible personal property" in conjunction with the reference to IRC section 1245(a) precludes incorporation of IRC section 1245(a)(3)(B), (C), (D), (E), and (F); the property in IRC section 1245(a)(3)(B) through (F) cannot be termed tangible personal property. We also note the mutually exclusive definitions of "tangible personal property" and "other property" found in Treasury Regulation section 1.1245-3(b) (defining tangible personal property) and Treasury Regulation section 1.1245-3(c) (defining other property), thus also precluding incorporation of IRC section 1245(a)(3)(B) into the California scheme.

We do not believe appellant's position comports with the language adopted by the legislature in section 23649, subdivision (d). If the statute defined qualified property as "property" that is defined in IRC section 1245(a), or "tangible property" that is defined in IRC section 1245(a), appellant's argument to include IRC section 1245(a)(3)(B) through (F) would appear more persuasive. Section 23649, subdivision (d), however, does not refer only to "property," or to "tangible property," but to "tangible personal property." In our opinion, this language necessarily limits the kind of property treated as qualified property under IRC section 1245(a). Finally, appellant's argument that nothing is added to the definition of "tangible personal property" for California purposes by the reference to IRC section 1245(a) if we adopt respondent's approach is unfounded. To the contrary, respondent's approach incorporates a rich and well established body of law for our utilization.

Appellant alleges the tanks and concrete tank foundations are qualified property because they are an "integral part" of the wine manufacturing process. This allegation, however, further illustrates the reason IRC section 1245(a)(3)(B) does not fit within the MIC statutory scheme. IRC section 1245(a)(3)(B) indicates "other property" qualifies as "section 1245(a) property" (and thus qualifies under the MIC) if it "was used as an integral part of manufacturing, production, or extraction or of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services." This provision includes activities, such as extraction and furnishing communications and electrical energy, either specifically excluded or not identified in section 23649 as acceptable MIC activities. We do not find it appropriate to administratively add qualifying activities when section 23649, subdivision (d)(1), specifically identifies activities qualifying for the MIC. Clearly, section 23649, subdivision (d)(1), not IRC section 1245(a), governs the acceptable uses of MIC property.

Given the size of the tanks and the nature of the concrete tank foundations, respondent asserts its application of the definition of tangible personal property as set forth in Treasury Regulation section 1.48-1(c) necessarily leads to an analysis of whether or not the tanks and the concrete tank

foundations are inherently permanent structures under *Whiteco Industries, Inc., et al. v. Commissioner* (1975) 65 T.C. 664. The case of *Whiteco Industries, Inc., et al. v. Commissioner* sets forth six-factors to guide the determination of whether or not specific property is tangible personal property, rather than an inherently permanent structure, under Treasury Regulation section 1.48-1(c) for purposes of the federal investment tax credit. Specifically, the court sought to determine whether or not outdoor billboards constituted tangible personal property, or inherently permanent structures. The court set forth the following six factors culled from other federal cases to guide its determination: (1) Is the property capable of being moved, and has it in fact been moved?; (2) Is the property designed or constructed to remain permanently in place?; (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 a job is removal of the property and how time-consuming is it? Is it 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? Respondent's analysis produced the following conclusions with respect to the tanks and the foundations: (1) The tanks and foundations had never been moved; (2) the tanks and foundations were designed to remain permanently in place; (3) appellant expressed no plans to move the tanks or foundations; (4) the tanks were not readily movable since they would need to be cut into pieces, and the concrete foundations would be destroyed; (5) the tanks and foundations would experience substantial damage (e.g., the tanks would be cut into sections in order to be moved), even if repairable; and (6) the concrete foundations were permanently affixed to the land. With these conclusions in mind, respondent determined the tanks and the foundations were inherently permanent structures. Respondent also concluded the tanks and foundations were in no way in the nature of a machine or machinery.

Appellant argues respondent's reliance on the concept of the tanks as "inherently permanent structures" is irrelevant, as well as wrong. First, appellant states the tanks can be moved. Appellant provides several affidavits from engineers in support of this contention. Second, appellant contends respondent misapplies its own regulation with regard to the permanence of the tanks. Appellant asserts respondent relies incorrectly on the sixth sentence of Regulation section 23649-5, subdivision (b)(1), rather than on the fifth sentence. The sixth sentence says that property will be treated as an inherently permanent structure and not tangible personal property if the property is affixed permanently and incapable of being moved, while the fifth sentence says property in the nature of machinery will be considered tangible personal property, regardless of whether or not it is an inherently permanent structure. With this in mind, appellant states it makes no sense to focus on the size of the tanks, and stresses the tanks and the tank foundations comprise an integral part of the wine manufacturing process, and thus constitute machinery, which is treated as tangible personal property under the MIC.

With respect to *Whiteco Industries, Inc., et al. v. Commissioner, supra*, appellant agrees the tax court established the six-factor analysis used by respondent, but also points out that the tax court found, after applying the test, the outdoor billboards to be tangible personal property. Appellant also cites another federal investment tax credit case, *Weirick v. Commissioner, supra*, which found the supporting towers of chair-type ski lifts to be tangible personal property under Treasury Regulation section 1.48-1(c). In *Weirick*, the Internal Revenue Service conceded that inherently permanent structures in the nature of machinery qualify as tangible personal property. A third federal case cited by appellant, *Marineland of the Pacific, Inc. v. Commissioner* (1975) ¶ 75,288 P-H Memo TC, determined a 338-foot tower gondola ride to be tangible personal property. These cases, appellant suggests, reveal respondent's erroneous analysis of inherently permanent structures.

We agree respondent's reliance on and incorporation of the relevant Treasury Regulations necessarily includes the relevant federal case law interpreting and applying those regulations. Thus, we approve of respondent's reliance on the *Whiteco* six-factor analysis guiding the determination of whether property is tangible personal property or an inherently permanent structure. We disagree, however, with the result respondent reaches after its application of the *Whiteco* factors in this appeal, and offer guidance to respondent with respect to future application of the analysis. Upon review of the six factors set forth and applied in *Whiteco*, we conclude the guiding principle when applying the six-factor *Whiteco* analysis should be whether the property at issue can reasonably be moved and placed back into productive use without damaging the property. We offer that applying this principle avoids the need for respondent to examine a taxpayer's subjective intent with regard to the future use of the property at the time the property was placed into service and allows taxpayers to make decisions regarding manufacturing property motivated by business needs, rather than tax considerations. We believe this 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.)

With respect to the current appeal, we first conclude the 215,000 gallon fermentation tanks and the concrete tank foundations are not machines or in the nature of machinery. Although the tanks and tank foundations are utilized by appellant in the manufacture of wine, this does not automatically implicate them as machines or machinery, nor do we find them to be such. It is thus appropriate to apply the six-factor *Whiteco* analysis to determine whether the tanks or the foundations constitute inherently permanent structures, or tangible personal property.

Upon application of the *Whiteco* factors, keeping in mind the guiding principle outlined above, we conclude: 1) Appellant submitted sufficient evidence to support its argument that the tanks may be moved. We do not find the fact that these tanks have not been moved to be

fatal to appellant's claim. On the other hand, mobility alone is not decisive. (*Marineland of the Pacific, Inc. v. Commissioner, supra,* ¶ 75,288 P-H Memo TC.) The concrete foundations do not appear capable of being moved; 2) Realistically, the tanks and the foundations were designed and constructed to remain permanently in place, although this finding by itself is not decisive. (See *Weirick v. Commissioner, supra*, 62 T.C. at p. 449.) As discussed above, however, the tanks, but not the foundations, may be moved if desired; 3) In the current appeal, we see no evidence to indicate the taxpayer had an expectation or intention for the length of affixation of the tanks and foundations. Respondent argues appellant had not planned to move the tanks when they were installed. As we discussed earlier, however, and we believe this to be a key consideration, a business may or may not be able to foresee its future growth and the necessary changes to its facilities. This factor alone should not be decisive in determining whether property qualifies for the MIC, and thus we will tend to apply this factor in particular in a liberal manner to accomplish the purposes of the MIC; 4) Although we do not believe the evidence supports the tanks are "readily" movable, the cost estimates for moving the tanks provided in the record indicate moving the tanks may be less of an undertaking than purchasing and constructing new tanks. It does not appear the foundations are either readily or economically movable; 5) The evidence suggests the tanks may or may not need to be "disassembled" (i.e., cut into sections) in order to move them. If the tanks do not need to be disassembled, it appears the tanks would suffer no damage during moving. If, on the other hand, the tanks need to be disassembled, respondent argues the tanks would experience substantial damage, although repairable. We do not consider disassembly to equate to damage. The term "damage" indicates harm or injury to the property, whereas disassembly merely indicates taking apart the property. We also note respondent's own Regulation section 23649-5, subdivision (b)(1), recognizes "production machinery, printing presses, and testing equipment" as tangible personal property. We speculate that equipment of this nature would necessitate disassembly before being moved from one location to another, yet this does not preclude respondent from designating these items of property as tangible personal property. In our opinion, a taxpayer purposely disassembling property does not constitute damage. On the other hand, the poured-in-place concrete foundations apparently would need to be broken up to be moved and thus would suffer damage, which cannot be deemed disassembly, in order to be moved; 6) The tanks rest on concrete foundations and are bolted to metal straps imbedded in the foundation for purposes of earthquake safety. Thus, the tanks are not truly affixed to the ground. Regardless of this fact, affixation to land does not per se exclude the property from qualifying as tangible personal property. (*Whiteco Industries, Inc., et al. v. Commissioner, supra*, 65 T.C. at p. 672.) The foundations, however, by

their very nature become affixed to the ground in such a fashion that removal would inflict substantial and irreparable damage on the foundations.[9]

As a result of applying the *Whiteco* analysis, we conclude appellant's 215,000 gallon tanks, but none of the concrete tank foundations, are tangible personal property, and thus qualified property under the MIC. We believe our application of the *Whiteco* analysis to the present appeal acknowledges both the legislative intent and our stated direction to liberally construe the MIC in favor of taxpayers, while keeping in mind that not every piece of equipment qualifies for the MIC. We also believe we have illustrated the balancing of factors which must occur under the *Whiteco* analysis.

[9] We recognize Revenue Ruling 79-183 allowed concrete foundations as tangible personal property. (Rev. Rul. 79-183, 1979-1 C.B. 44.) In that case, however, the issue was whether the concrete foundations were a component of the building or part of the machinery. The IRS determined the foundations to be part of the machinery, and thus tangible personal property. In the current appeal, we specifically determined the tanks were not machinery. Thus, the foundations must satisfy the *Whiteco* analysis, which they fail to do.

O R D E R

Pursuant to the views expressed in the opinion of the Board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED, AND DECREED, pursuant to section 19333 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the claim of Bronco Wine Company for refund of franchise tax in the amount of $35,362 for the year ended September 30, 1996, be and the same is hereby reversed with respect to the 215,000 gallon tanks and sustained with respect to all the concrete tank foundations.

Done at Sacramento, California, this 13th day of November, 2002, by the State Board of Equalization, with Board Members John Chiang, Johan Klehs, Dean Andal, Claude Parrish and *Ms. Marcy Jo Mandel present.

John Chiang, Chairman

Johan Klehs, Member

Dean Andal, Member

Claude Parrish, Member

*Ms. Marcy Jo Mandel, Member

Bronco_rs

* For Kathleen Connell per Government Code section 7.9