

IN THE MATTER OF THE APPEAL OF:)
)
STREMICKS HERITAGE FOODS, LLC,) File No. 20086443
)
 APPELLANT.)
_____)

Job No. :
42730 OTA(A)

1 BEFORE THE OFFICE OF TAX APPEALS

2 STATE OF CALIFORNIA

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5 IN THE MATTER OF THE APPEAL OF:)
6 STREMICKS HERITAGE FOODS, LLC,) File No. 20086443
7 APPELLANT.)
8 _____)

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15 TRANSCRIPT OF PROCEEDINGS, taken at
16 12900 Park Plaza Drive, Suite 300, Cerritos,
17 California, commencing at 9:40 a.m. and
18 concluding at 10:46 a.m. on Wednesday,
19 July 12, 2023, reported by HANNA JENKIN,
20 Hearing Reporter.
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25

1 APPEARANCES:

2 Panel Lead: ANDREW KWEE

3 Panel Members: TERESA STANLEY
4 SARA HOSEY

5 For the Appellant: KEVIN ACORD, ATTORNEY
6

7 For the Respondent: STATE OF CALIFORNIA
8 DEPARTMENT OF TAX AND
FEE ADMINISTRATION

9 CARY HUXSOLL, TAX COUNSEL
10 PAMELA BERGEN, TAX COUNSEL
JASON PARKER, HEARING REP.
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I N D E X

E X H I B I T S

(Department's Exhibits A-D were received at page 7)

(Appellant's Exhibits 1-20 were received at page 8)

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By Mr. Acord 10

By Mr. Huxsoll 33

APPELLANT'S
WITNESS:

DIRECT CROSS REDIRECT RECROSS

J. Noenickx 27

C L O S I N G S T A T E M E N T

P A G E

By Mr. Acord 41

1 Cerritos, California, Wednesday, July 12, 2023

2 9:40 a.m.

3
4
5 JUDGE KWEE: We are opening the record in the Appeal
6 of Stremicks Heritage Foods, LLC. This matter is being
7 held before the Office of Tax Appeals. The Office of Tax
8 Appeals Case Number is 20086443. And today's date is
9 Wednesday, July 12th, 2023. The time is approximately
10 9:40 a.m. This hearing is being live-streamed at OTA's
11 public YouTube channel and is being conducted in Cerritos,
12 California.

13 Today's hearing is being held by a panel of three
14 Administrative Law Judges. My name is Andrew Kwee and I
15 will be the lead ALJ. The other members of this panel, to
16 my right are Judge Teresa Stanley, and to my left, Judge
17 Sara Hosey, and they are the other members of the panel.
18 We are equal participants on this panel. Even though I
19 will be conducting this hearing today, we will be meeting
20 as equal participants, and any member of this panel and
21 they ask questions or interrupt the proceeding at any time
22 to ensure that we have all the information required to
23 decide this appeal.

24 For the record, I'm going to ask that the parties
25 state their names. And I will start with representatives

1 for the tax agency.

2 MR. HUXSOLL: Cary Huxsoll from the department's legal
3 division.

4 MS. BERGEN: Pamela Bergen, CDTFA Legal Division.

5 MR. PARKER: And Jason Parker, Chief of Headquarters,
6 Operations Bureau.

7 JUDGE KWEE: And I will turn to the representative for
8 the taxpayer.

9 MR. ACORD: Kevin Acord, attorney for the accountant.

10 MR. NOENICKX: Jack Noenickx, Chief Financial Officer
11 of Stremicks Heritage Foods.

12 JUDGE KWEE: I understand for the witnesses, CDTFA
13 doesn't have any witnesses. And the witness for Appellant
14 is Jack Noenickx, the CFO.

15 MR. ACORD: Yes.

16 JUDGE KWEE: I also understand CDTFA has no objection
17 hearing testimony from this witness.

18 MR. HUXSOLL: That is correct.

19 JUDGE KWEE: Okay. Perfect.

20 Before I go further, I'm just going to swear you
21 in now, Mr. Noenickx. Would you please raise your hand?

22 J. NOENICKX,
23 Produced as a witness, and having been first duly sworn by
24 The Administrative Law Judge, was examined and testified
25 as follows:

1 JUDGE KWEE: Great. Thank you.

2 So I will go on to the exhibits. CDTFA had
3 provided Exhibits A through D and those exhibits were
4 distributed to the parties and sent as an attachment to
5 the minutes and orders following our prehearing conference
6 earlier last month.

7 CDTFA, I did not receive any additional exhibits.

8 And for Appellants, I did not receive any
9 objections to the admittance of CDTFA's exhibits.

10 Is that correct for CDTFA?

11 MR. HUXSOLL: That's correct.

12 JUDGE KWEE: Okay. And is that correct for Appellant?
13 There's no objections? Procedural objections?

14 MR. ACORD: Yes.

15 JUDGE KWEE: Okay. Great. So I will admit CDTFA's
16 Exhibits A through D into the evidentiary record without
17 objection from Appellants.

18 (Department's Exhibits A-D were received in
19 evidence by the Administrative Law Judge.)

20 JUDGE KWEE: For Appellants, the Exhibits 1 through 20
21 were provided with the minutes and orders. And I also
22 received a copy of Exhibits 1 through 20 today and there's
23 no changes from the prior submission. I understand that
24 CDTFA has no procedural objections to admitting Exhibits 1
25 through 20.

1 Is that correct for CDTFA?

2 MR. HUXSOLL: Yes.

3 JUDGE KWEE: Okay. And for Appellant, you don't have
4 any additional exhibits? It's just Exhibits 1 through 20?

5 MR. ACORD: Correct.

6 JUDGE KWEE: Okay. So Appellant's Exhibits 1 through
7 20 are admitted into the evidentiary record without
8 objection from CDTFA.

9 (Appellant's Exhibits 1-20 were received in
10 evidence by the Administrative Law Judge.)

11 JUDGE KWEE: So with that said, I will just briefly
12 skip to the issue. I understand that there is only one
13 issue in this appeal and that issue is whether Appellant
14 established a basis for adjustment to the measure of
15 unreported ex-tax purchases of repair parts.

16 The entire measure is disputed less than 3.2
17 million and the minutes and orders that we sent out
18 following the conference also listed several items which
19 were not in dispute. In the interest of time, I'm not
20 going to repeat them here because they were summarized in
21 the minutes in orders, but I will check with the parties
22 that the minutes and orders correctly summarized the items
23 that were not in dispute.

24 CDTFA, did you review the minutes and orders?

25 MR. HUXSOLL: Yes, I did.

1 JUDGE KWEE: Okay. And did the minutes and orders
2 accurately summarize the issue and the items that we
3 discussed the prehearing conference that were agreed by
4 the parties?

5 MR. HUXSOLL: Yes, they did.

6 JUDGE KWEE: Okay. And for Appellant, I'll turn to
7 you, did the minutes and orders accurately summarize the
8 issues and the items that were agreed by the parties?

9 MR. ACORD: Yes.

10 JUDGE KWEE: Okay. And I will just give everyone a
11 quick recap of the procedure order we're going through.
12 So we were going to start with Appellant's opening
13 presentation, followed by witness testimony, and we had
14 reserved approximately 90 minutes for that portion. At
15 that point, we return to CDTFA's opening presentation
16 where we had reserved 20 minutes.

17 During either presentation, the panel could ask
18 questions of either party. And then following questions,
19 we would turn over to closing remarks, each party has
20 allocated five minutes for any closing remarks.

21 Does that order -- does that sound correct?
22 CDTFA, is that your understanding?

23 MR. HUXSOLL: Yes.

24 JUDGE KWEE: Okay. And Appellant, is that also your
25 -- is that a correct summary of the order of presentation

1 for you?

2 MR. ACORD: Yes.

3 JUDGE KWEE: Great. Then I believe we are ready to
4 get started.

5 Does anyone -- I'll start with CDTFA, do you have
6 any questions or concerns before we get started today?

7 MR. HUXSOLL: No.

8 JUDGE KWEE: Okay. And a, are you ready to get
9 started? Do you have any questions before we turn it over
10 to you for your opening presentation.

11 MR. ACORD: No questions. But you'll be happy to
12 hear, I think based on your order, I think we can
13 eliminate some of the things that was going to talk about.
14 I'm sure everybody would be happy about that.

15 JUDGE KWEE: All right. Oh, so you're not -- is that
16 going to revise your time estimate for today?

17 MR. ACORD: Yeah. I'm anticipating it's going to be
18 half of that, 30 minutes.

19 JUDGE KWEE: Oh, okay. Then I will turn it over to
20 you. And we have the whole morning, so if you go over we
21 still have time for you because you're the only hearing in
22 the morning, but if not, the floor is yours.

23
24 PRESENTATION

25 MR. ACORD: I appreciate that. I obviously do not

1 want to regurgitate things that you've already seen and I
2 think we briefed this issue ad infinitum.

3 So anyway, I'd like to kind of focus on a little
4 bit -- give you a little background, a little history. So
5 as you know, this deals with 2015 to 2017. The issue at
6 hand is whether or not Stremicks, which is a manufacturer
7 of we call food products -- Mr. Noenickx will testify
8 later as to exactly what type of food products Stremicks
9 manufacturers -- but there is an exemption in the R&TC
10 6377.1 that allows for a partial exemption of sales tax
11 for tangible personal property that is uses used or
12 purchased in connection with the manufacturing activity.

13 That's the focus of today. We're going to be
14 focusing on a very narrow issue. There's a case by the
15 name of Owens that has been previously decided by the OTA
16 that seems to be in conflict, but I'm going to explain to
17 you why I believe the OTA decision -- the Owens decision
18 is not correct.

19 A little background here, the dispute that we
20 have centers around the interpretation of 6377.1 and
21 specifically, the definition of useful life. And if
22 you'll bear with me, I just want to read a couple of
23 sections of 6377.1. And you'll notice that -- and that's
24 in, if you want to pull that out, it's in our Exhibit 4.

25 So 6377.1(b)(9)(A)(ii) talks -- if you read it,

1 it says, "Equipment or devices used or required to
2 operate, control, regulate, or maintain the machinery,
3 including, but not limited to, computers, data-processing
4 equipment, computer equipment, together," and here's the
5 key word, "with all repairs replacement parts with the
6 useful life of one year or one or more years."

7 And the subject matter here in almost all of the
8 items tested by the CDTFA in their audit are repair parts
9 or we would call them that classification. So
10 6377.1(b)(9)(A)(ii) is directly applicable.

11 And then 6377.1(b)(9)(B)(i) talks about what is
12 not qualified tangible personal property and it says,
13 "Consumables with a useful life of less than one year."

14 And then in -- further below in 6377.1(b)(13)(a)
15 has the definition of useful life. It says, "Useful life
16 or tangible personal property that is treated as having a
17 useful life of one or more years." And we'll be talking
18 about that word, "treated" later.

19 "For for state income or franchise tax purposes
20 shall be deemed to have a useful life of one or more years
21 for purposes of this section.

22 Useful life or tangible personal property is
23 treated as having a useful life of less than one year for
24 state or franchise tax purpose shall be deemed to have a
25 useful life of less than one year for purposes of this

1 section."

2 The last sentence in that paragraph deals with an
3 expensing provision that's equivalent to the Internal
4 Revenue Code Section 179 for California purposes as not
5 applicable here.

6 So the question is: Useful life the way it's
7 defined is tied back to the treatment for state income or
8 franchise tax purposes, so that's the key and that's the
9 thing I'd like to focus on here today. The CDTFA'S
10 position is that this is very simple, that Stremicks
11 deducted the repair parts in question, they were not
12 capitalized, not depreciated, therefore they said they
13 don't qualify for the exemption. So in a very simplistic
14 word or in way you could read this section to say that.

15 But a little history about capitalization and
16 where the law that's associated with that, I think is
17 appropriate. So if we go back in time, IRC, Internal
18 Revenue Code Section 2638 and Code Section 167 developed a
19 body of law on capitalization and this whole concept of
20 something that needs to be capitalized is actually more
21 than a year, and I know the statute says one or more
22 years, I'm not sure if that was intended by the
23 legislature or not, the CDTFA had some comments on some of
24 the briefing with respect to that, and I'm not sure what
25 the intent was there.

1 But it's clear in the Internal Revenue Code that
2 the intent in the regulations and also the case law that
3 basically says if something has a useful life of more than
4 a year it's to be depreciated. And so that's the law that
5 we've lived with for many years. California adopted the
6 Internal Revenue Code as it existed in 2009, so it adopted
7 the whole history and the regulations that came around the
8 history of capitalization.

9 So a little background, so there's always been
10 consternation with taxpayers about what does have a useful
11 life of more than a year. There's been a lot of
12 litigation, there are a lot of tax court cases that you
13 will go out and find, you will find all kinds of
14 decisions, and after a period of time the IRS decided that
15 fighting that issue one-by-one, especially for small
16 amounts of money, did not make any sense.

17 So the Treasury took upon probably in the late
18 2008, 2009 they took upon a project called the Tangible
19 Property Regulations and they spent many years drafting
20 these regulations. The intent of these regulations was to
21 bring some semblance of order to the litigation that had
22 been going on in the industry, and trying to reduce the
23 number of tax court cases that are going on, on a federal
24 level.

25 The Tangible Property Regulations were issued in

1 September of 2013, they were later modified, finalized
2 2014, and then the IRS basically gave permission in a
3 revenue procedure in 2015 to do a change in accounting
4 method to adopt them. These regulations were then adopted
5 by the State of California, the State of California had
6 the opportunity to not adopt them or to follow them, but
7 they chose to do to follow them as well.

8 And the speculation would be, why would
9 California do that? They obviously are going to, in some
10 cases, allow people to deduct things that have a useful
11 life of more than a year, and deduct them currently.

12 Well, the reason that California adopted the --
13 what we call the Tangible Property Regulation is the same
14 reason that the IRS just was pushing for this. They
15 wanted an administrative solution to a substantial
16 litigation issue.

17 So these property regulations, well, they were
18 drafted and again, followed by the Franchise Tax Board,
19 contained what we call a safe harbor de minimus standard.
20 And as we all know, there's all kinds of safe harbors and
21 all kinds of legislations designed to provide some level
22 of certainty for the taxpayer and the government.

23 And in the case of Tangible Property Regulations,
24 the treasury regulations allow a taxpayer who has what
25 they call an applicable financial statement to deduct any

1 item that has a cost of \$5000 or less. And if you have an
2 applicable financial statement, that basically means
3 either you are a public company or you have a certified
4 audit by a CPA.

5 And why is that important? Because if you have
6 an applicable financial statement, you have to follow --
7 if your policy for expensing or capitalizing, in this
8 case, for book purposes you cannot expense anything for
9 tax purposes that you have capitalized for book purposes.

10 So you say well what's the relevance of that?
11 Well, so in general accepted accounting principles -- and
12 I'm a CPA as well as an attorney, so I have a little
13 background in this -- auditors would come in and audit
14 clients all the time, and they don't comb through your
15 fixed assets to determine whether every aspect or every
16 asset have a useful life of a year or more, that's the
17 standard.

18 But auditors live by a rule we call materiality.
19 And so they go in, they test things, and they have a
20 materiality level, they have a scope, and they develop
21 these materiality levels. And this has been going on in
22 the world of general accepted accounting principles for a
23 very long time, and this is the solution that the gap
24 world came up with to solve this issue of these small
25 numbers of items that potentially could have a life of

1 more than one year.

2 So but, to -- so you've got that backdrop of a
3 general accepted accounting world started this, this
4 materiality on fixed assets and they have it in other
5 aspects of financial statements. So really when you look
6 at it, the Tangible Property Regulations are really just
7 kind of a subset and following what's been going on in the
8 public reporting world, certainly any firm that's been
9 audited. So that's the history that we are looking at
10 here, how did we get to where we're at?

11 Now, the rub is in 6377. The way 6377 drafted
12 with respect to the useful life, the history of
13 capitalization was very simple, if it had a life of more
14 than a year, you capitalize it and depreciate it. If that
15 had a life of year less, you expense it. And that's, in
16 6377.1(b)(13)(A), that's what's really drafted there,
17 that's what they're trying to say.

18 Now, that's great because that was the history of
19 capitalization, that was the law of federal purposes,
20 California followed that, we all kind of understood that.
21 So when this is drafted, there wasn't any distinction,
22 there wasn't any reason for dispute.

23 So now we come along, Tangible Property
24 Regulations are issued by the treasury, California adopts
25 them, and they create this de minimus exception that

1 basically says you know what, anything that is \$5000 or
2 less, even if it has a useful life of a year or more,
3 we're going to let you deduct it currently. Changed the
4 law, changed the rules.

5 California had the option of either following or
6 not following those rules. Franchise Tax Board chose to
7 follow them, I think they chose them for administrative
8 convenience.

9 Now, the CDTFA argues that well, what the
10 Franchise Tax Board does doesn't matter in this context
11 because this is a Sales and Use Tax hearing. Well, the
12 problem with that is 6377.1(b)(13)(A) directly refers back
13 to a deduction for state income tax, income, or franchise
14 tax purposes. So it's really no way you can ignore what
15 the Franchise Tax Board has done because they are the ones
16 who dictated this result, that now you can insert in
17 limited cases for administrative convenience, you can
18 deduct currently an item that has a useful life of more
19 than 1 year.

20 And I really can't emphasize the history, how we
21 got to where we're at, I can't emphasize enough how the
22 history, how we got where we are, or how 6377.1(b)(13)(A)
23 was drafted, and it was drafted exactly for audit
24 administrative convenience. They didn't -- California
25 didn't want their auditors out trying to argue whether

1 something had a useful life of a year or more. And I can
2 understand that, I totally get it, but now we've got to
3 change in -- we've got a change in the law. And it
4 doesn't say anywhere in 6377.1(b)(13)(A) that you have to
5 depreciate, I see nothing there.

6 And if the State follows the Tangible Property
7 Regulations and they allow for an item that has a useful
8 life of more than one or more years to be deducted, well,
9 that doesn't change the fact that the item in question
10 still has a life of more than one year.

11 So I don't think (b)(13)(A) is inconsistent with
12 the current interpretation, I think just we need to
13 understand the history, how we got here, and now the
14 change in the Tangible Property Regulations has caused.

15 Now, the Owens case, and I'm gonna read a passage
16 out of that order and this is on page 5 of the order,
17 second full paragraph. It says, "In order to qualify for
18 the exemption," and maybe a little background on the Owens
19 case, just before we start.

20 The Owens case -- the issue is very similar to
21 ours if not identical, the only difference is, in the
22 Owens case it dealt with what they call non-depreciated
23 molds, which I'm not exactly sure what a mold is, but I
24 have an idea. But in the context of a mold, just reading
25 through the opinion, I guess the parties agreed that the

1 molds had a useful life of two and a half years for
2 federal income tax purposes and apparently that was
3 followed for California purposes.

4 However, as was the case -- as is the case here
5 with Stremicks, Owens also adopted these Tangible Property
6 Regulations because the amount was less than \$5000, it was
7 deducted. The OTA's decision is based on the fact that --
8 this is somewhat simplistic -- but they basically said
9 they declined to expand the interpretation of, well the
10 interpretation of useful life in 6377.1(b)(13)(A).

11 I would beg to differ with them, I don't think
12 you're trying to expand the definition, I think you're
13 trying to interpret it what it says.

14 But anyway, back to page 5. It says, "In order
15 to qualify for the exemption," and we're talking about the
16 6377.1, "the law requires that the property at issue be
17 depreciated over a useful life of one year or more." Then
18 it goes on to talk about statutory exceptions associated
19 with section 179 which doesn't apply here.

20 There is nowhere in 6377.1 that says the property
21 has to be depreciated. I'm going to let that sink in.
22 There is nowhere in 6377.1 that requires property to be
23 depreciated. The history caused that because of the
24 history of capitalization before the adoption of Tangible
25 Property Regulations. And so everybody has gone down this

1 mental path of thinking things have to be depreciated
2 because that's how it's been done. We've got to change
3 the mindset, law is changed, it has changed in California.

4 With respect to our exhibits, because of your
5 order Judge Kwee, we have a number of exhibits, really
6 starting with 9 to 20 that are either warranty or
7 affidavits. I don't believe there's any dispute now
8 whether our repair parts have a useful life of more than
9 one year. I think the CDTFA has agreed with that, so I'm
10 not going to spend a whole lot of time on those exhibits,
11 9 to 20.

12 Our other exhibits are mainly our briefs, the law
13 that we just went through, 6377.1, and then attached news
14 flash that talks about the California adopting the
15 Tangible Property Regulations. And if there's any -- you
16 have any questions with regard to any of the warranties or
17 the affidavits -- the warranties are specifically for
18 those -- some of our vendors who would give, they give a
19 warranty where the property is going to last more than one
20 year. So really what we're trying to say there is, if
21 they're going to give a warranty of more than one year
22 then obviously it has a life of more than one year.

23 The affidavits are all mostly just employees who
24 would -- are going to assert, and Mr. Noenickx is here
25 today so he can testify specifically to his affidavit, but

1 these affidavits are really just to support the fact that
2 the repair parts in question do have a useful life of more
3 than one year.

4 And I think that's -- like I said, I was going to
5 shorten it up. I may have shortened it even more than I
6 thought, but I think that's all I have.

7 JUDGE KWEE: Okay. Before you go to witness
8 testimony, I am just going to check with the panel members
9 to see if there are questions about your arguments. I'll
10 start with Judge Stanley.

11 Judge Stanley, do you have any questions?

12 JUDGE STANLEY: I don't at this time.

13 JUDGE KWEE: Okay. Judge Hosey, did you have any
14 questions for the representative?

15 JUDGE HOSEY: No questions at this time. Thank you.

16 JUDGE KWEE: Okay. I did have one question -- thought
17 about the 6377.1(b)(13)(A). When you were talking about,
18 you know, how the property is treated -- sorry, I'll bring
19 the microphone a little closer -- how the property is
20 treated for state income tax purposes, and you know how it
21 says that if it's treated as having a useful life of one
22 or more years for state income tax purposes, it is deemed
23 to have the qualified useful life for the section. If
24 it's treated as having a useful life of less than a year,
25 then it's deemed to not qualify.

1 And I guess looking at the Owens-Brockway
2 decision by -- precedential decision by OTA, that seems to
3 be saying that if you depreciate it over more than one
4 year for state income tax purposes, you know, that's what
5 it means to treat it as having a useful life of one or
6 more year. But if you expense it in the year of purchase,
7 you know, whether as a de minimis or just an expense, then
8 that is being treated as having a useful life of less than
9 one year because it's all expensed in that same year.

10 And then that's the reason why there's a specific
11 carve out for the 17201 and 17255. And they're saying
12 that if you expense it pursuant to those provisions, even
13 though it's expensed in one year, we are going to deem it
14 as having a useful life of more than one year.

15 So it seems to be that's what the Owens-Brockway
16 decision is saying, but then I understand your position,
17 you're saying that because it's a safe harbor, it should
18 still be treated as having a useful life of more than one
19 year.

20 I guess I'm not entirely understanding the
21 reasoning for saying something which is an expense in the
22 year purchased as having a useful life of more than one
23 year if it's not specifically listed as qualifying.

24 Could you clarify that a little bit? What was
25 the rationale for, you know, saying that even though it's

1 a de minimis expense under the safe harbor, it would still
2 be treated as having a useful life of more than one year
3 for purposes of this partial exemption?

4 MR. ACORD: Sure. So I think that again, probably
5 just a step back a couple seconds. So the Tangible
6 Property Regulations, one thing when you read them and you
7 read, you know, kind of the initial language on those
8 regulations, those regulations are very clear when they
9 say that they are not changing the law. Okay. That's
10 number one.

11 However, they are creating statutory deductions
12 that would not otherwise exist for administrative
13 convenience. So the Tangible Property Regulations did not
14 change the rule that property has a useful life of more
15 than one year should be depreciated.

16 However, for administrative purposes only,
17 they're allowing a safe harbor that says you know what, we
18 don't want to fight with taxpayers over small amounts of
19 money, and we've got too much of that going on in the tax
20 court, clogging up the tax courts, cases take lot of time,
21 we want these resolved. And not just in tax courts,
22 you've got the appeals process, and the IRS that clogs up
23 that system as well.

24 So the Tangible Property Regulations, and
25 specifically de minimus, is specifically for assets that

1 have a useful life of more than one year. You can't use
2 the de minimus exception unless the asset has a life of
3 more than one year. So if you want to challenge me on
4 that I'll tell you why that's the case.

5 So if the treasury -- if the Tangible Property
6 Regulations had this concept called materials and
7 supplies, and in there they say if something is a material
8 and supply, it's currently deductible. And even in the
9 frequently asked questions that are available on the IRS'
10 website, there is a question that says, "Well if I buy
11 something for more than \$2,500, does that automatically
12 mean it's not deductible?"

13 And the IRS came back quickly and said, "No. If
14 it's a material and supply, if it meets that definition,
15 it doesn't matter how much it costs. It's currently
16 deductible."

17 So let's not get -- we should not get confused
18 about materials and supplies that are currently
19 deductible, versus an asset has a useful life of more than
20 one year. And materials and supplies are things that are
21 consumed in a year. That basically IRS' distinction.

22 So again, why do we have the de minimus
23 exception? It doesn't change the law that those assets
24 have a useful life of more than one year. To the
25 contrary, it says an administrative determination by, a

1 treasury that says, "We're going to allow these deductions
2 currently, and we're going to create this safe harbor for
3 people that they can expense those at these designated
4 levels, in applicable financial statements is \$5000 per
5 item."

6 JUDGE KWEE: Okay. That helps. So it's really
7 twofold, one is the policy and allowing the deductions
8 under the safe harbor, and then two, in order to qualify
9 for that safe harbor anyway, it would have had to have an
10 actual useful life of more than one year, otherwise it
11 would have been expensed anyway. I understand. Thank
12 you. That helps clarify.

13 MR. ACORD: Thank you.

14 JUDGE KWEE: And just another quick clarification. So
15 with respect to the gap between the treatment under the
16 Sales and Use Tax provision, the one day gap and how it's
17 treated on the income tax side. Your position is that's
18 not relevant here, that's just probably an oversight, but
19 it doesn't change any of the analysis for purposes of this
20 appeal.

21 MR. ACORD: That would be my position, correct.

22 JUDGE KWEE: Okay. And then as far as the
23 Owens-Brockway case, you are not distinguishing your case,
24 the facts of your case from that precedential decision.
25 Your position is that the Owens-Brockway case was

1 incorrectly decided. Is that a correct understanding?

2 MR. ACORD: Yes.

3 JUDGE KWEE: Great. That helps clarify this for me.
4 I appreciate your responses. And I will turn it back to
5 you for witness testimony now.

6 MR. ACORD: Thank you. Jack Noenickx is our witness,
7 he's already been sworn in.

8
9 DIRECT EXAMINATION

10 BY MR. ACORD:

11 Q And so Mr. Noenickx, could you tell the panel
12 your position with the company and your responsibilities?

13 A My position is chief financial officer. I have
14 been with the company for 38 years. Responsibilities are
15 to oversee all aspects of finances and administration,
16 that would include tax, taxes, and tax administration.

17 Q And you dealt directly with the CDTFA's auditors
18 with respect to the Sales and Use Tax exam?

19 A Yes, I did as well as some of my staff.

20 Q Okay. Could you go through that process?

21 A Well, the process was the auditor came at some
22 point in 2018 and reviewed invoices, looked at trial
23 balances, and concentrated on repairs and maintenance
24 accounts for our California plants. We have plants in
25 other states also.

1 At that point in time, she went through hundreds
2 of invoices as examples. And at one point came to me and
3 wanted to see the tax returns for 2015 through 2017, so I
4 give her the tax returns as kind of like in my office one
5 simple thing. She goes to one particular provision and
6 sees no activity on section 179 and says, "Oh. These
7 partial exemptions you've been doing for repair parts are
8 not eligible."

9 I said, "What do you mean? They have a useful
10 life of one year or more. I've never had any questions
11 about particular parts not being -- having a useful life
12 for a year or more." She said, "Well, you're not
13 depreciating." I said, "Well, I am not depreciating
14 because of the Tangible Property Regulations we adopted
15 for our financial statements back in 2014."

16 We are taxpayers. My job is to make as much
17 money for the company as possible and sometimes that
18 involves tax avoidance. I would rather pay less taxes
19 today by not -- and you know, pay more in the future, so
20 to speak. So you take that deduction today, you're paying
21 that cash out today, you're interested in cash.

22 So I couldn't understand that argument and that
23 reasoning. And I said, "I don't see that as being the
24 case regarding this particular measure." I remember the
25 governor's office coming to me a couple years, or a year

1 or two prior, we were part of the enterprise zone,
2 California had what was called an enterprise zone.

3 And our particular plant, I got involved -- I was
4 directly involved in establishing enterprise zones for the
5 City of Santa Ana. They said, "We're removing that and
6 we're going to start this partial sales tax deduction.
7 And don't worry, you're going to have the same amount of
8 deductions, if not more based on the size of your business
9 and all the activity you do."

10 We are a beverage manufacturer. And we
11 manufacture items for -- we do co-man, co-manufacturing,
12 so items like Muscle Milk and Coffee mate and Nestle
13 creamers, various brand names you may be aware of, Jenny
14 Craig shakes, Weight Watcher shakes, things of that
15 nature.

16 So we deal a lot in high temperature processing
17 and a lot of processes we do we're dealing with
18 temperatures between 270 to 300 degrees Fahrenheit. And
19 products that can be ambient as well as refrigerated and
20 last for 14 to 15 months, so it requires that great deal
21 of maintenance.

22 As far as beverage goes, it would be a high tech
23 portion of the business, so we have quite a few repair
24 parts. Our machines, we get a filling machine and a
25 filling machine can be fifteen to twenty million dollars,

1 so there's a lot that goes into maintaining them.

2 But anyway, that was the extent of the audit.
3 And it was really no discussion, you got to take it up
4 with my supervisor, and at that point I dealt with
5 supervision, appeals, and so forth.

6 MR. ACORD: Okay. I'm gonna have Mr. Noenickx look at
7 Exhibit 15, which is his affidavit, if you wanna turn to
8 that.

9 BY MR. ACORD:

10 Q So this is an affidavit of useful parts and
11 equipment. Mr. Noenickx, did to you sign this?

12 A Yes, I did.

13 Q Okay. Prior to your review -- to signing this,
14 you reviewed the CDTFA's Worksheet 12A-3, is that correct?

15 A That is correct.

16 Q Okay. And did you find anything on the CDTFA's
17 worksheet that would indicate that any of those items
18 would not have a useful life of more than a year?

19 A No, I did not.

20 MR. ACORD: Okay. I don't have any other questions of
21 the witness.

22 JUDGE KWEE: Okay. I'll start by turning it over to
23 CDTFA to see if they have any questions for the witness.

24 MR. HUXSOLL: No questions.

25 JUDGE KWEE: Okay. Then I will next turn to the

1 panel.

2 Judge Stanley, did you have any questions for the
3 witness?

4 JUDGE STANLEY: No, I don't. Thank you.

5 JUDGE KWEE: Judge Hosey, did you have any questions
6 for the witness?

7 JUDGE HOSEY: No questions. Thank you for your
8 testimony.

9 JUDGE KWEE: Okay. I just have one question. From my
10 understanding is that, but for the 5-K de minimis
11 provision, your company would have depreciated the items
12 listed in the schedule attached to you your affidavit. Is
13 that a correct understanding?

14 MR. NOENICKX: A large part of them we would, yes.

15 JUDGE KWEE: Okay. Thank you. I don't have any other
16 -- oh. So as far as a large part, what would the
17 remaining property be treated as then?

18 MR. NOENICKX: It would have been expensed.

19 JUDGE KWEE: Oh, okay. Under --

20 MR. ACORD: In this case --

21 MR. NOENICKX: But in this case, more items are
22 expensed because of adopting the Tangible Property
23 Regulations.

24 JUDGE KWEE: Okay.

25 MR. ACORD: I think his question is, historically,

1 before the adoption of the Tangible Property Regulations,
2 were those items capitalized and depreciated on the
3 federal tax term.

4 MR. NOENICKX: Yes, they would be.

5 MR. ACORD: Which would be corresponding --

6 MR. NOENICKX: Yes, they would be.

7 MR. ACORD: I think that is the question.

8 JUDGE KWEE: Yeah. That was I was trying to get at
9 how it was treated before they were -- yeah.

10 MR. NOENICKX: Yes, it would be.

11 JUDGE KWEE: Okay. Great. Thank you.

12 MR. ACORD: I prepared that tax return, so I can tell
13 you that was indeed the case.

14 JUDGE KWEE: Great. Thank you. Then I don't have any
15 further questions for the witness.

16 Did you have any further comments? Or would you
17 like to turn it over to CDTFA for their presentation?

18 MR. ACORD: I'm good. Thank you.

19 JUDGE KWEE: Okay. Then we are -- I'm sorry. Judge
20 Stanley, I believe, has a question.

21 JUDGE STANLEY: Yes. You were -- we're talking about
22 a small amount of cost, right? The 5,000 or less for
23 these parts. Is there are reason why you didn't use
24 section 179?

25 MR. ACORD: We weren't eligible.

1 JUDGE STANLEY: Okay.

2 MR. ACORD: Section 179 has a cap, a maximum amount
3 that you can elect in any one year, and Stremicks is a
4 very large company and they exceed that cap every year.
5 They spend a lot of money on, as Jack said, these machines
6 are very expensive. And you know, they spend easily well
7 into the millions every year on new equipment, lines, et
8 cetera.

9 JUDGE STANLEY: Got it. Thank you.

10 MR. ACORD: Thank you.

11 JUDGE KWEE: Okay. Great.

12 Then I will turn it over to CDTFA for your
13 presentation. I believe you reserved 20 minutes for your
14 presentation. The floor is yours. Thank you.

15
16 PRESENTATION

17 MR. HUXSOLL: Good morning. Before I begin I would
18 like to note that we found out at the last minute that the
19 attorney, who has been the lead on this case since the
20 initial briefing in 2020, would not be attending today's
21 hearing. Nonetheless, we plan to present our case and
22 address any questions the panel may have.

23 That being said, depending on the nature of the
24 questions, we may request to file post-hearing briefing to
25 answer any questions we are unable to answer today

1 At issue in this appeal is whether Appellants
2 have established a basis for adjustments to the measure of
3 unreported ex-tax purchases of repair parts. It is the
4 department's position that the transactions at issue could
5 not qualify for the partial exemption set forth in section
6 6377.1 because the property did not have a useful life of
7 one or more years under the statute.

8 On December 13, 2018, the Department issued
9 Appellant a Notice of Determination for \$132,732 in tax,
10 plus applicable interest for the period of January 1st,
11 2015 through December 31st, 2017, this is Exhibit B.

12 Appellant timely filed a petition for
13 redetermination on December 17th, 2018, this is Exhibit C.

14 Appellant, a Delaware limited liability company
15 with locations in California, manufacturers food products
16 which it sold to food retailers during the liability
17 period.

18 For the liability period, Appellant reported
19 total sales of just over \$960,000,000. All of which it
20 claimed was nontaxable sales for resale and ex-tax
21 purchases of just over \$1.3 million dollars, subject to
22 use tax.

23 JUDGE STANLEY: Mr. Huxsoll, can I ask you to slow
24 down a little bit you're reading?

25 MR. HUXSOLL: Okay. Sorry.

1 JUDGE STANLEY: You're reading and I want the
2 stenographer to be able to keep up with you.

3 MR. HUXSOLL: Okay. Sorry about that.

4 Upon audit, Appellant provided its general ledger,
5 purchase invoices for 2016, and its federal income tax
6 returns for 2015 and 2016. The Department found that
7 Appellants purchased repair parts from California vendors
8 who only -- found Appellants had purchased repair parts
9 from California vendors who only collected tax
10 reimbursements from Appellant at a partial rate.

11 Appellant stated that its purchases from those
12 vendors qualified for the partial exemption set forth in
13 Revenue and Taxation Code Section 6377.1. It provided
14 partial exemption certificates to these vendors.

15 The Department disallowed the partial exemption
16 because it found that Appellant did not treat the parts as
17 having a useful life of one or more years for California
18 income tax purposes. It did not capitalize and depreciate
19 any of the repair parts in its 2016 Income Tax Return and
20 it did not expense the repair parts pursuant to IRC
21 Section 179.

22 Appellant expensed the parts for California and
23 federal income tax purposes pursuant to Treasury
24 Regulation 1.263(a)-1(f), which allows eligible property
25 to be deducted in the year of purchase.

1 This is the de minimis safe harbor. Section
2 6377.1, subdivision (a)(1) partially exempts from the
3 Sales and Use Tax the sale and the storage, use, or other
4 consumption of qualified, tangible personal property,
5 purchased for use by a qualified person to be used
6 primarily in any stage of the manufacturing, processing,
7 refining, fabricating, or recycling of tangible personal
8 property.

9 Qualified tangible personal property includes
10 machinery and equipment, and repair and replacement parts
11 with a useful life of one or more years. Qualified
12 tangible personal property does not include consumables
13 with a useful life of less than a year.

14 Tangible personal property that the qualified
15 person treats as having a useful life of one or more years
16 for state income or franchise tax purposes shall be deemed
17 to have a useful life of one or more years for purposes of
18 section 6377.1.

19 Tangible personal property that is treated as
20 having a useful life of less than one year for state
21 income or franchise tax purposes shall be deemed to have a
22 useful life of less than one year for purposes of section
23 6377.1.

24 Tangible personal property that is deducted under
25 Revenue and Taxation Code Sections 17201 and 17255 or

1 Section 24356 shall be deemed to have a useful life of one
2 or more years. This provision was added to section 6377.1
3 in 2017, this one exception was added by the legislature
4 after the de minimis safe harbor was added to California
5 Law.

6 Under sections 17201, and 17255, and 24356,
7 California conforms with some modifications to the federal
8 election to deduct as an expense, the cost of qualifying
9 property under IRC Section 179, rather than to recover
10 such cost through depreciation deductions.

11 Under section 17201 and section 24422.3,
12 California conforms to the Uniform Capitalization Rules of
13 IRC Section 263A and Treasury Regulation Section
14 1.263(a)-1(f), here, Appellant's California businesses
15 purchased repair parts for use in California. Appellant
16 provided its vendors with a partial exemption certificate
17 when purchasing the parts.

18 However, Appellant did not depreciate the parts,
19 nor did it expense the parts pursuant to IRC Section 179.
20 This means that Appellant did not treat the parts as
21 having a useful life of one or more years for California
22 Income Tax purposes under section 6377.1, subdivision
23 (b)(13)(a).

24 To meet this useful life requirement as discussed
25 in Owens-Brockway, the law requires that the property at

1 issue be depreciated over useful life of one year or more,
2 and the only statutory exception to that rule is when
3 property is expensed pursuant to IRC Section 179.

4 Here, Appellant expensed the parts in the year of
5 purchase, pursuant to the de minimis safe harbor election
6 which does not constitute treatment of the parts as having
7 a useful life of one year or more under Section 6377.1.

8 The Office of Tax Appeal's precedential opinion
9 in Owens-Brockway Glass Container is directly on point in
10 this case and concludes that I.M.'s expensed under the de
11 minimis safe harbor election do not have a useful life of
12 one year or more for purposes of section 6377.1. And such
13 purchases cannot qualify for the partial exemption.

14 Thus, because Appellant expensed the parts under
15 the de minimis safe harbor election, Appellant did not
16 treat the parts as having a useful life of one or more
17 years for California Income Tax purposes as required by
18 section 6377.1.

19 We concur with the Office of Tax Appeals analysis
20 in Owens-Brockway and department handles this issue in
21 accordance with this precedential opinion, including for
22 this matter. The appeal should be denied.

23 This concludes my presentation. Thank you.

24 JUDGE KWEE: Thank you. I will turn to the panel
25 first to see if there are any questions. I will start

1 with Judge Stanley.

2 Judge Stanley, do you have any questions for
3 CDTFA?

4 JUDGE STANLEY: Yes. Just one.

5 What is the department's position on -- the
6 argument on the other side is partially that the de
7 minimis safe harbor does not apply unless the item has a
8 useful life of greater than one year. Wouldn't that be
9 consistent with treating it as having a useful life
10 greater than one year?

11 MR. HUXSOLL: The Department concurs with the analysis
12 of the Owens-Brockway memorandum opinion that this is not
13 the case, and that the partial exemption cannot be applied
14 here, that the partial exemption does not apply in this
15 case under that precedential opinion.

16 JUDGE KWEE: No further questions from Judge Stanley,
17 so I will turn it over to Judge Hosey.

18 Judge Hosey, did you have questions for CDTFA?

19 JUDGE HOSEY: No questions. Thank you for your
20 presentation.

21 JUDGE KWEE: I just have a procedural question. My
22 understanding is that these were ex-tax purchases, so they
23 didn't pay the state portion, or I guess the county
24 portion, or is it only the issue of the partial exemption
25 amount?

1 MR. HUXSOLL: My understanding from the record is the
2 partial exemption amount that they provided their vendors.
3 But I would --

4 MR. PARKER: Yes. That is correct. They paid tax to
5 their vendor at the partial exemption rate, so it's
6 disallowing the partial exemption portion.

7 JUDGE KWEE: Okay. I think I need to adjust the issue
8 statement which I used from the CDTFA's decision was
9 unreported ex-tax purchases of repair parts, but if these
10 were reported and claimed as exempt then I believe they
11 phrasing would need to be adjusted slightly to clarify
12 that it's claimed exemption amounts, instead of unreported
13 ex-tax purchases.

14 So I will make an adjustment to the issue of
15 statement to reflect that it was reported as subject to a
16 partial exemption, so then the decision -- OTA's opinion
17 will reflect a slightly revised issue statement than what
18 was provided previously in the minutes and orders.

19 MR. HUXSOLL: Just to clarify, these were items
20 purchased by Appellant where Appellant provided an
21 exemption certificate and Appellant -- it was purchased
22 subject to the partial exemption, so that's where the
23 measure comes from is the amount that was not paid to the
24 vendor based on the partial exemption. Just wanted to
25 make sure that was clarified for the record.

1 JUDGE KWEE: Okay. Great. Since we are talking about
2 how Appellant reported, just confirm that's also your
3 understanding for Appellant's representative that the tax
4 was paid on the county and it's only -- the issue is the
5 state's partial exempt portion that's that issue.

6 MR. ACORD: I am going to let Mr. Noenickx answer
7 that.

8 MR. NOENICKX: No, that is exactly correct.

9 JUDGE KWEE: Perfect. Thank you for that.

10 I believe we are ready to move on to closing
11 presentations so I'll turn it over to Appellant's
12 representative.

13 You have five minutes for any closing remarks.
14

15 CLOSING STATEMENTS

16 MR. ACORD: Thank you.

17 So I think the panel can see the conundrum we
18 have here. I don't think it's fair for a California
19 taxpayer to have Franchise Tax Board allow and pass, in
20 essence adopt regulations that allow a deduction, and then
21 turn around and use that as a tool to then say that
22 they're not available for partial exemption when they've
23 qualified for it, really since this legislation was
24 enacted. And then prior to that, Stremicks qualified
25 under the Enterprise Zone Regulation.

1 So there is a fundamental fairness question here
2 that the facts have not changed. The adoption of the
3 Tangible Property Regulations by California should not
4 change the answer here. And again, to do so is
5 fundamentally unfair.

6 I think the CDTFA not wanting to address the de
7 minimis issue, I think is telling because it's very hard
8 for them to argue under the de minimis, all of those
9 assets have a useful life of more than one year, otherwise
10 there would be no purpose for using the de minimus
11 exception.

12 So again, that's the issue with the
13 Owens-Brockway case, in my opinion. I'm not sure whether
14 that issue was properly vetted to that panel, but I'm
15 hoping that this panel can get the flavor of our argument.
16 I think the equivalent of 179 deduction with the 17201,
17 17255 and 204356, what I'll call the small company
18 expensing election, it would be great if we qualified for
19 that, but we don't.

20 But again, there was no reason to have to change
21 the law, I'm talking about 6377, you don't have to because
22 the way it's written, Tangible Property Regulations are
23 consistent with what is now the law in California after
24 adoption of the Tangible Property Regulations.

25 Thank you.

1 JUDGE KWEE: Okay. I will turn it over to CDTFA.

2 CDTFA, you have five minutes for any closing
3 remarks.

4 MR. HUXSOLL: We have no further remarks.

5 JUDGE KWEE: Okay. I believe we're ready to conclude,
6 I'll just double check with the panel.

7 Judge Stanley, are you ready to conclude the
8 hearing today?

9 JUDGE STANLEY: Yes. I have no further questions.
10 Thank you for your presentations.

11 JUDGE KWEE: Judge Hosey, are you ready to conclude
12 the proceeding today?

13 JUDGE HOSEY: Yes. Thank you to both parties for
14 presenting today.

15 JUDGE KWEE: Okay. Great. Then so we are ready to
16 conclude the Appeal of Stremicks Heritage Foods. This
17 case is submitted on Wednesday July 12th, 2023. The
18 record is now closed.

19 (Hearing concluded at 10:46 a.m.)
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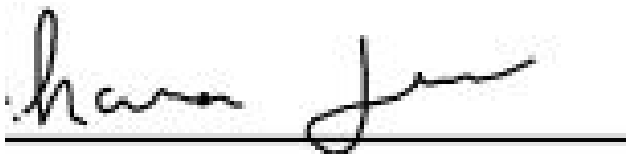
CERTIFICATE
OF
HEARING REPORTER

The undersigned hearing reporter does hereby certify:
That the foregoing was taken before me at the time and
place therein that any witnesses in the foregoing
proceedings were duly sworn; that a record was made of the
proceedings by me using a machine shorthand, recorded
stenographically, which was thereafter transcribed under
my direction.

I further certify I am neither financially interested
in the action nor a relative or employee of any attorney
or party to this action.

Dated July 12, 2023

Hanna Jenkin

A handwritten signature in cursive script, appearing to read 'Hanna Jenkin', is written over a solid horizontal line.

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