**OFFICE OF TAX APPEALS**

**STATE OF CALIFORNIA**

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| In the Matter of the Appeal of: | OTA Case No. 20086443 |
| | CDTFA Case ID: 186-966 |
| **STREMICKS HERITAGE FOODS, LLC** | |

# OPINION

Representing the Parties:

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| For Appellant: | Kevan D. Acord, Representative<br>Jack Noenickx, Chief Financial Officer |
| For Respondent: | Jason Parker, Chief of Headquarters Ops.<br>Cary Huxsoll, Attorney<br>Pamela A. Bergin, Assistant Chief Counsel[1] |
| For Office of Tax Appeals: | Corin Saxton, Attorney IV |

A. KWEE, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, Stremicks Heritage Foods, LLC (appellant) appeals a decision issued by respondent California Department of Tax and Fee Administration (CDTFA)[2] denying appellant's petition for redetermination of a Notice of Determination (NOD) dated December 13, 2018. The NOD is for $132,732 in tax, plus applicable interest, for the period January 1, 2015, through December 31, 2017 (liability period).

Office of Tax Appeals (OTA) Administrative Law Judges Andrew J. Kwee, Teresa A. Stanley, and Sara A. Hosey (Panel) held an oral hearing for this matter in Cerritos, California, on July 12, 2023. At the conclusion of the oral hearing, the record was closed and this matter was submitted on the oral hearing record pursuant to California Code of Regulations, title 18, (Regulation) section 30209(b).

[1] Standing in for Kevin Smith, Attorney.

[2] Sales and use taxes were formerly administered by the State Board of Equalization (board). In 2017, functions of the board relevant to this case were transferred to CDTFA. (Gov. Code, § 15570.22.) For ease of reference, when this Opinion refers to acts that occurred before July 1, 2017, "CDTFA" refers to the board.

## ISSUE

Whether appellant's purchases of repair parts expensed pursuant to the de minimis safe harbor for income tax purposes qualify for the partial sales and use tax exemption.[3]

## FACTUAL FINDINGS

1. Appellant manufactures and sells food products.
2. Appellant operates business locations throughout the United States, including in Santa Ana and Riverside counties, both in California.
3. During the liability period, appellant issued partial exemption certificates to its suppliers pursuant to R&TC section 6377.1 when it purchased repair parts for use in California. The partial exemption certificates allowed appellant to purchase the repair parts subject to the partial tax exemption. Appellant self-reported and claimed the partial exemption on purchases from suppliers who were not registered with CDTFA to collect sales or use tax.
4. CDTFA audited appellant for the liability period and, in pertinent part, disallowed the claimed partial exemption on the basis that appellant's repair parts are not qualified tangible personal property (first requirement to claim the partial exemption).[4]
5. CDTFA identified a deficiency measure of $3,233,919 for disallowed claimed purchases of repair parts subject to the partial exemption during the liability period.[5]
6. On December 13, 2018, CDTFA issued the NOD to appellant for the liability disclosed by audit, which appellant timely petitioned.
7. On May 7, 2020, CDTFA issued a decision denying appellant's petition. This timely appeal followed.
8. On appeal to OTA, the parties stipulate and agree that only the first requirement (that the repair parts must be qualified tangible personal property) is at issue. The parties further agree that the other two requirements to claim the partial exemption are satisfied

[3] CDTFA's decision identified this issue as "unreported ex-tax purchases of repair parts." During the oral hearing, both parties agreed that appellant reported and/or paid the local and district taxes (which are not subject to the partial exemption), or reimbursement therefor, to its vendors. The parties further agreed that the only issue in dispute was the disallowed claimed exempt state tax component of the sales and use tax rate.

[4] R&TC section 6377.1, in pertinent part, allows a partial tax exemption when (1) qualified tangible personal property is (2) purchased by a qualified person (3) for use in a qualifying manufacturing activity.

[5] The deficiency measure is based on a block test of 2016. The audit methodology is not in dispute.

(i.e., appellant is a qualified person, and appellant is engaged in a qualifying manufacturing activity).

9. The parties also acknowledge that there is a statutory ambiguity in the Sales and Use Tax Law because R&TC section 6377.1(b)(13)(A) applies a presumption tracking franchise and income tax treatment, but the language of the R&TC section 6377.1 presumption does not correspond with the cited franchise and income tax law due to a one-day discrepancy in the applicable test periods.[6] Furthermore, appellant concedes that the statutory discrepancy with the cited franchise and income tax law does not have any bearing on the outcome of this case.[7]

10. During a pre-hearing conference, and as confirmed during the oral hearing, both parties agree that OTA may accept the following facts:

    a. The repair parts at issue were expensed pursuant to the de minimis provision for certain property costing less than $5,000. (See IRC, § 263A; 26 C.F.R. § 1.263(a)-1(f); R&TC, § 24422.3.)
    b. The repair parts at issue were not expensed pursuant to Internal Revenue Code (IRC) section 179, or the California equivalent. (See R&TC, § 24356).
    c. CDTFA did not assert a penalty for the underreporting.

11. The parties also acknowledge that OTA addressed this specific issue in a precedential Opinion, *Appeal of Owens-Brockway Glass Container, Inc.,* 2019-OTA-158P (*Owens-Brockway*), which held that the first requirement (qualified tangible personal property) can only be met for expensed property if the property is expensed pursuant to IRC section 179 (for federal tax purposes) or the California franchise and income tax equivalent (for state income tax purposes).

[6] In briefing submitted to OTA, CDTFA conceded that there is a statutory ambiguity, but maintains that the ambiguity does not change the analysis: "It is the Department's position that in referring to tangible personal property that the qualified person treats as having a useful life of less than one year for state income or franchise tax purposes, [R&TC section] 6377.1, subd. (b)(13)(A), must be interpreted to mean property that has a useful life of 12 months or less and is, therefore, generally expensed pursuant to Internal Revenue Code (IRC) section 167. [Citation omitted.] Conversely, in referring to tangible personal property that the qualified person treats as having a useful life of one or more years for state income or franchise tax purposes, R[&]TC section 6377.1, subdivision (b)(13)(A), must be interpreted to mean property that has a useful life of more than 12 months and is, therefore, generally capitalized and depreciated pursuant to IRC section 162."

[7] Appellant confirmed during the hearing its position is that the discrepancy is probably an oversight and not relevant here and would not change the analysis under the facts of this appeal.

## DISCUSSION

California imposes sales tax on a retailer's gross receipts from the retail sale of tangible personal property in this state unless the sale is specifically exempt or excluded from taxation by statute. (R&TC, §§ 6012, 6051.) For the purpose of the proper administration of the Sales and Use Tax Law and to prevent the evasion of the sales tax, the law presumes that all gross receipts are subject to tax until the contrary is established. (R&TC, § 6091.) A purchaser that issues a partial exemption certificate for property purchased subject to the partial exemption in R&TC section 6377.1 is liable for payment of the sales tax if the requirements of the partial exemption are not met. (Cal. Code Regs., tit. 18, § 1525.4(c)(1).) In addition, when sales tax does not apply, use tax applies to the storage, use, or other consumption in this state of tangible personal property purchased for storage, use, or other consumption in this state, measured by the sales price, unless that use is specifically exempted or excluded by statute. (R&TC, §§ 6201, 6401.)

When CDTFA is not satisfied with the amount of tax reported by the taxpayer, or in the case of a failure to file a return, CDTFA may determine the amount required to be paid on the basis of any information which is in its possession or may come into its possession. (R&TC, §§ 6481, 6511.) In the case of an appeal, CDTFA has a minimal, initial burden of showing that its determination was reasonable and rational. (*Appeal of Talavera*, 2020-OTA-022P.) Once CDTFA has met its initial burden, the burden of proof shifts to the taxpayer to establish that a result differing from CDTFA's determination is warranted. (*Ibid*.) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Ibid*.)

R&TC section 6377.1, in pertinent part, provides a partial exemption from sales and use tax when three requirements are met: (1) qualified tangible personal property; (2) qualified purchaser; and (3) qualifying use. The only issue in this appeal is the first requirement: the definition of qualified tangible personal property. For purposes of the partial exemption, qualified tangible personal property includes repair parts with a useful life of one or more years. (R&TC, § 6377.1(b)(9)(A)(ii).) Consumables with a useful life of less than one year are statutorily excluded from the definition of qualified tangible personal property. (R&TC, § 6377.1(b)(9)(B)(i).) There are also some statutory presumptions concerning the term "useful life":

> "Useful life" for tangible personal property that is treated as having a useful life of one or more years for state income or franchise tax purposes shall be deemed to

> have a useful life of one or more years for purposes of this section. "Useful life" for tangible personal property that is treated as having a useful life of less than one year for state income or franchise tax purposes shall be deemed to have a useful life of less than one year for purposes of this section. For the purposes of this paragraph, tangible personal property that is deducted under Sections 17201 and 17255 or Section 24356 shall be deemed to have a useful life of one or more years.

(R&TC, § 6377.1(b)(13)(A).) When read in conjunction with R&TC section 6377.1(b)(9), this language creates a presumption that repair parts for qualified tangible personal property treated as having a useful life of "one or more years" for franchise or income tax purposes will meet the first requirement for the partial exemption, and that repair parts treated as having a useful life of "less than one year" for franchise or income tax purposes will not qualify for the partial exemption. This statutory presumption is created because property with a useful life of less than one year is statutorily excluded from the definition of qualified tangible personal property, whereas repair parts with a useful life of one or more years are statutorily included in the definition of qualified tangible personal property; thus, application of the sales tax partial exemption for repair parts hinges on the income tax treatment. (R&TC, § 6377.1(b)(9)(A)-(B).)

The Statutory Ambiguity

As a preliminary matter, there is an apparent statutory ambiguity because the applicable franchise and income tax language applies a test of *one year or less* (to expense) and *more than one year* (to depreciate) whereas the applicable sales and use tax safe harbor grants one additional day to meet the useful life safe harbor requirement (i.e., the test is "one or more years"). (R&TC, § 6377.1(b)(13)(A); see IRC, §§ 162, 167; see also, e.g., IRS Pub. 946; IRS Tax Topic No. 704.) Thus, there is an apparent disconnect because property treated as having a useful life of *exactly* one year could be expensed in the year of purchase for income tax purposes but may nevertheless still qualify for the partial exemption for sales and use tax purposes because the applicable sales and use tax presumption applies a safe harbor test of "*one* or more years." (R&TC, § 6377.1(b)(13)(A).) This language (to meet the sales and use tax safe harbor) overlaps *both* income tax tests. Said another way, the sales and use tax safe harbor is greater (by one day) than the income tax safe harbor. Property with a useful life of exactly one year can be expensed for franchise and income tax purposes and nevertheless be "deemed to" meet the useful

life requirement of qualified tangible personal property for purposes of the sales and use tax partial exemption.

In this case, appellant contends that the repair parts at issue "have a useful life of longer than one year and are regularly used longer than one year." Thus, OTA understands and assumes that neither party is asserting that the property in question qualifies for the partial exemption on the basis that it was properly expensed under the safe harbor for having a useful life of one year, but is nevertheless presumed to meet the useful life requirement due to the one-additional-day allowed under the safe harbor language applied for sales and use tax purposes (see factual finding 9). Based on this understanding and assumption, OTA need not address whether the statutory ambiguity impacts the analysis under the facts of this case.[8]

Applicable OTA Precedent

In *Owens-Brockway*, *supra*, OTA held that with respect to property expensed in the year of purchase, the first requirement (qualified tangible personal property) can only be met if the property is expensed pursuant to IRC section 179 (for federal tax purposes) or the California franchise and income tax equivalent (for state franchise or income tax purposes).[9] OTA's precedential Opinion in *Owens-Brockway, supra*, which also did not address a factual scenario involving the statutory ambiguity (discussed above), explained the logic as follows:

> [T]he only statutory exception to that rule [that property must be depreciated] is when the property is expensed pursuant to IRC section 179. [Citation omitted.] We note that R&TC section 6377.1, subdivision (b)(13)(A), identifies a single instance in which a potentially depreciable asset that is deducted as an expense has a useful life of at least one year. The Legislature's identification of a single instance in which expensed assets meet the useful life requirement implies that the useful life requirement is not met in other instances where the asset is expensed.

Appellant contends that OTA incorrectly decided this case and asks that this Panel decline to follow *Owens-Brockway, supra*. In support, appellant contends that, for income tax purposes, the Franchise Tax Board follows the de minimis safe harbor provision for property costing less than $5,000 and allows a full deduction in the year of purchase for state franchise or income tax

[8] The statutory ambiguity issue would constitute a case of first impression before OTA, because it is not addressed or considered in *Owens-Brockway, supra,* or any other precedential OTA Opinion.

[9] The applicable franchise and income tax provisions are R&TC section 24356 (for taxes imposed under the Corporation Tax Law) and section 17201, as modified by 17255 (for taxes imposed under the Personal Income Tax Law).

purposes. (See IRC, § 263A; 26 C.F.R. § 1.263(a)-1(f); R&TC, § 24422.3.) As such, CDTFA should allow the partial exemption for property qualifying for the de minimis safe harbor and expensed in the year of purchase. Appellant asserts that requiring taxpayers to expense property pursuant to the safe harbor in IRC section 179 (or the California equivalent) in order to qualify, would render the de minimis safe harbor provision obsolete. Appellant next claims that it can provide documentation to support that the property in question had a useful life in excess of a year, and, during the hearing, appellant's witness provided testimony indicating that the repair parts were in service for more than one year. Finally, appellant contends that it is contrary to the stated intent of the statute to restrict the scope of the partial exemption, and that there is nothing in the plain text of R&TC section 6377.1 which requires limiting the sales tax safe harbor to property expensed pursuant to IRC section 179, or the California equivalent, and thus there is no authority for excluding property expensed pursuant to different federal income tax safe harbor provisions.

A taxpayer bears the burden of proving entitlement to an exemption or exclusion and must provide some credible evidence of that entitlement. (*Paine v. State Bd. of Equalization* (1982) 137 Cal.App.3d 438, 443.) A taxpayer has the burden of establishing its entitlement to a claim for refund. (*Honeywell, Inc. v. State Bd. of Equalization* (1982) 128 Cal. App.3d 739, 744.) The applicable burden of proof is by a preponderance of the evidence. (Cal. Code Regs., tit. 18, § 30219(b).) That is, a party must establish by documentation or other evidence that the circumstances it asserts are more likely than not to be correct. (*Owens-Brockway, supra*.)

Here, appellant is correct that the stated legislative intent is in favor of exempting manufacturing equipment. For example, in adopting R&TC section 6377.1, the Legislature included a statement of intent:

> It is the intent of the Legislature to exempt manufacturing equipment from state sales and use taxes in order to make California more competitive in attracting new businesses to the state, and to bring California in line with the 48 other states that exempt manufacturing equipment from sales and use tax.

(Stats. 2013, Ch. 69 (A.B. 93).) Appellant is also correct that the specific statutory language included a safe harbor in R&TC section 6377.1 which provides that property expensed pursuant to R&TC sections 17201 and 17255, or section 24356, will be regarded as meeting the useful life requirement for qualified tangible personal property. The safe harbor in R&TC section 6377.1 does not mention property expensed pursuant to the federal de minimis safe harbor claimed by

appellant. However, that would be expected because the federal de minimis safe harbor is an administrative convenience adopted pursuant to a Treasury Regulation, and it is not specifically set forth in the underlying statute. (See IRC, § 263A; 26 C.F.R. § 1.263(a)-1(f); R&TC, § 24422.3; see also IRS Rev. Proc. 2015-20].) Thus, it would not necessarily be expected for R&TC section 6377.1 to cite to a California de minimis conformity statute because there is no such statute.[10]

In summary, the statutory language does not specifically exclude property expensed pursuant to the income tax de minimis safe harbor from meeting the useful life requirement of qualified tangible personal property for sales and use tax purposes. Furthermore, while CDTFA could promulgate a regulation adopting such an interpretation, it has not done so. (R&TC, § 7051.) Thus, if this were a case of first impression before OTA, it appears that a panel would not be precluded by statute or regulation from interpreting the useful life requirement of qualified tangible personal property in the manner requested by appellant. Nevertheless, this is not a case of first impression. OTA has resolved this specific issue in *Owens-Brockway, supra,* and there is likewise nothing in the statute or regulation which would preclude an interpretation as adopted by OTA in that Opinion. The precedential status of *Owens-Brockway, supra,* has not been withdrawn. (Cal. Code Regs., tit. 18, § 30503.) As such, this Panel must follow the precedent set forth in *Owens-Brockway, supra.*[11] Appellant's purchases do not qualify for the partial exemption because appellant expensed the property pursuant to the de minimis safe harbor for income tax purposes.

[10] R&TC section 24422.3 generally conforms to IRC section 263A; however, the de minimis safe harbor is established in Treasury Regulation 1.263(a)-1(f).

[11] This Opinion, and existing OTA precedent, leave unaddressed the issue of whether property with a useful life of one year could be expensed for income tax purposes and still qualify for the partial sales tax exemption.

## HOLDING

Appellant's purchases of repair parts expensed pursuant to the de minimis safe harbor for income tax purposes do not qualify for the partial sales and use tax exemption.

## DISPOSITION

CDTFA's action is sustained.

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Andrew J. Kwee
Administrative Law Judge

We concur:

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Teresa A. Stanley
Administrative Law Judge

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Sara A. Hosey
Administrative Law Judge

Date Issued: 9/25/2023