

**BEFORE THE HEARING OFFICER
OF THE TAXATION AND REVENUE DEPARTMENT
OF THE STATE OF NEW MEXICO**

**IN THE MATTER OF THE PROTEST OF
REA MAGNET WIRE COMPANY, INC.
CRS ID NO. 02-336367-003
DENIAL OF INVESTMENT CREDIT**

No. 00-30

DECISION AND ORDER

A formal hearing on the above-referenced protest was held October 17, 2000 before Margaret B. Alcock, Hearing Officer. Rea Magnet Wire Company, Inc. ("Taxpayer") was represented by Jody Grunden, CPA, its Tax & Treasury Supervisor. The Taxation and Revenue Department ("Department") was represented by Monica M. Ontiveros, Special Assistant Attorney General. Based on the evidence and arguments presented, IT IS DECIDED AND ORDERED AS FOLLOWS:

FINDINGS OF FACT

1. The Taxpayer is engaged in the business of manufacturing magnet wire.
2. In 1998, the Taxpayer constructed a manufacturing facility in Las Cruces, New Mexico.
3. The Taxpayer's decision to locate its facility in New Mexico was influenced, at least in part, by the tax credits available under New Mexico's Investment Credit Act.
4. During construction of the plant, the Taxpayer hired Deloitte & Touche, LLP, to perform a cost segregation analysis on the construction costs to determine the useful lives of the plant components and the items qualified for the tax credits provided under the Investment Credit Act.

5. On January 26, 1999, the Taxpayer filed an application for \$318,700 of investment credit, which represented 5 percent of the value of various items of equipment listed on schedules submitted by the Taxpayer.

6. On May 14, 1999, the Department partially approved the Taxpayer's application for investment credit in the amount of \$293,706; the Department denied the Taxpayer's application for \$24,994 of investment credit.

7. On June 16, 1999, the Taxpayer protested the Department's partial denial of the Taxpayer's application for investment credit. The protest was initially denied as untimely, but was subsequently accepted after the Department granted the Taxpayer's July 8, 1999 retroactive request for an extension of time to file the protest.

8. The disputed investment credit was denied based on the Department's determination that \$499,871 of the purchases listed on the Taxpayer's equipment schedules did not meet the definition of "equipment" set out in Section 7-9A-3(B) NMSA 1978 of the Investment Credit Act.

9. The disputed items fall into one of the following three categories of property: (1) the plant's supplemental electrical system; (2) the plant's air conditioning units (HVAC units); and (3) the plant's "high bay area".

10. A supplemental electrical line and breaker system was installed in the Taxpayer's manufacturing plant to provide adequate electrical flow to the sensitive equipment used in the manufacturing process.

11. Although the supplemental system was installed for the sole purpose of providing adequate electricity to plant equipment, it was not possible to limit the flow of electricity from the system strictly to the equipment. For this reason, some of the electricity from the supplemental system is used for general plant operations.

12. Pursuant to federal tax regulations and IRC § 168, the Taxpayer allocated the cost of the supplemental electrical system between operation of the equipment and operation of the plant. The portion allocated to the equipment was depreciated as 7-year property and the portion allocated to the plant was depreciated as 39-year property (described in IRC § 168 as “nonresi-dential real property”).

13. The Department approved the Taxpayer’s application for investment credit on the portion of the supplemental electrical system depreciated as 7-year property, but denied the credit on the portion depreciated as 39-year property

14. The Taxpayer installed air conditioning units in its manufacturing plant. Although not specifically necessary to the operation of the manufacturing equipment, the air conditioning was necessary to maintain a comfortable climate for personnel working in the plant.

15. For federal tax purposes, the Taxpayer depreciated the air conditioning units as 39-year property.

16. The Department denied the Taxpayer’s application for investment credit on the value of the air conditioning units.

17. The Taxpayer’s plant was constructed with a raised roof over one section of the building to accommodate special 70-foot ovens known as “high bay vertical enameling ovens”. This high bay area of the building also required special concrete flooring to support the weight of the ovens.

18. The high bay area of the plant is not a machine, mechanism or tool, nor is it a fitting or component of a machine, mechanism or tool.

19. For federal tax purposes, the Taxpayer depreciated the enameling ovens as 7-year property and depreciated the high bay area of the plant as 39-year property.

20. The Department granted the Taxpayer's application for investment credit on the value of the ovens but denied the credit on the cost of constructing the high bay area of the plant.

DISCUSSION

The Investment Credit Act was enacted in 1979 to provide a favorable tax climate for manufacturing businesses and to promote increased employment in New Mexico. Section 7-9A-2 NMSA 1978. The Act provides a credit equal to 5 percent of the value of "qualified equipment", which is defined in Section 7-9A-6 NMSA 1978 as equipment not previously used in New Mexico or previously approved for the credit which is incorporated into a manufacturing operation in New Mexico. Pursuant to Section 7-9A-7 NMSA 1978, the value of qualified equipment is its adjusted basis under the applicable provisions of the Internal Revenue Code. Section 7-9A-3 defines the terms equipment, manufacturing, and manufacturing operation as follows:

B. "equipment" means an essential machine, mechanism or tool, or a component or fitting thereof, used directly and exclusively in a manufacturing operation and subject to depreciation for purposes of the Internal Revenue Code by the taxpayer carrying on the manufacturing operation. "Equipment" does not include any vehicle that leaves the site of the manufacturing operation for purposes of transporting persons or property or any property for which the taxpayer claims the credit pursuant to Section 7-9-79 NMSA 1978;

C. "manufacturing" means combining or processing components or materials, including recyclable materials, to increase their value for sale in the ordinary course of business, including genetic testing and production, but does not include:

- (1) construction;
- (2) farming;
- (3) power generation; or
- (4) processing natural resources, including hydrocarbons;

D. "manufacturing operation" means a plant, including a genetic testing and production facility employing personnel to perform production tasks, in conjunction with equipment not previously existing at the site, to produce goods;

At issue in this case is whether the Taxpayer is entitled to the investment credit on the value of the supplemental electrical system and air conditioning units installed in its manufacturing plant and

on the cost of constructing the high bay area of the plant. The Department maintains these items do not qualify for the credit because they are components of the building depreciated for federal tax purposes as 39-year property (described in IRC § 168 as “nonresidential real property”). It is the Department’s position that only equipment depreciated as 7-year property is eligible for the investment credit. For this reason, the Department approved the investment credit on the portion of the supplemental electrical system allocated to operation of plant machinery and depreciated as 7-year property, but disallowed the credit on the portion of the same system allocated to general operation of the plant and depreciated as 39-year property. The Department disallowed the credit on the air conditioning units because the units were designed to cool the entire plant and depreciated as part of the building. The Department disallowed the cost of constructing the high bay area because this area is a structural component of the building depreciated as 39-year nonresidential real property.

The Taxpayer acknowledges that the Department’s position is consistent with Regulations 3.13.2.9 NMAC and 3.13.2.10 NMAC under Section 7-9A-6 NMSA 1978, the statute defining qualified equipment. The Taxpayer concedes that the items in dispute would not qualify for the investment credit under the current regulations. It points out, however, that these regulations only became effective April 28, 2000. A substantially different version was in effect during 1998 and 1999 when the Taxpayer constructed its plant and filed its application for investment credit. The Taxpayer argues that it qualified for the credit under the earlier version of the regulations and the Department is estopped from denying the credit based on subsequent amendments. *See*, Section 7-1-60 NMSA 1978. The Department does not dispute that the Taxpayer’s protest is governed by the regulations in effect prior to April 2000. Rather, the Department maintains that its position can be supported even under this earlier version.

The regulations at issue, which were in effect from September 1996 until April 2000, read as follows:

3 NMAC 13.6.9 - ITEMS NOT "EQUIPMENT"

Tangible personal property which is not a machine, mechanism or tool, or a component or fitting thereof, is not equipment for the purpose of the Investment Credit Act. Accordingly such items as furniture, shelving and supplies are not "equipment".

3 NMAC 13.6.10 - ITEMS WHICH MAY BE INCLUDED AS "EQUIPMENT"

The term "manufacturing operation" is defined to be the plant in which manufacturing takes place. Equipment need not be employed exclusively in the manufacturing process as long as the equipment is employed in the plant in which the manufacturing process occurs. Therefore, for the purpose of the Investment Credit Act, "equipment" may include, but is not limited to, such items as manufacturing process equipment, lights, boilers, air conditioners, computers and peripherals, air compressors, water chillers, refrigeration equipment, water treatment equipment, packaging equipment, warehousing equipment and electrical control equipment if such items are used directly and exclusively in the plant in which the manufacturing takes place.

Based on these regulations, the Taxpayer must establish that each item of property for which it seeks the investment credit is a machine, mechanism or tool, or a component or fitting thereof, and is employed in the plant in which the manufacturing process occurs. There is nothing in the regulations to support the Department's contention that equipment is not eligible for the credit unless it is sufficiently tied to the plant's manufacturing process to be depreciated as 7-year personal property. To the contrary, 3 NMAC 13.6.10 specifically provides that "equipment need not be employed exclusively in the manufacturing process as long as the equipment is employed in the plant in which the manufacturing process occurs." The regulation goes on to state that for purposes of the Investment Credit Act, the term equipment may include air conditioners and electrical control equipment—two of the items in dispute in this protest—"if such items are used directly and exclusively in the plant in which the manufacturing takes place."

With regard to the requirement in Section 7-9A-3(B) that equipment must be subject to depreciation, the pertinent version of Regulation 3 NMAC 13.6.7.1 defines this term as follows:

For purposes of Section 7-9A-3, “subject to depreciation” means the equipment must be depreciated on the books and records of the taxpayer and that the expense of the depreciation shall be reflected on the federal income tax return as a depreciation expense. Equipment depreciated under the accelerated cost recovery system, I.R.C. 168, and property for which the taxpayer makes an election under Internal Revenue Code Section 179 shall also qualify for the credit.

Neither the statute nor the regulation require equipment to be depreciated as 7-year property in order to qualify for the investment credit. The Department relies on Regulation 3 NMAC 2.1.11.11, which provides, in pertinent part:

11.11.2 A "building" includes the structural components integral to the building and necessary to the operation or maintenance of the building but does not include equipment, systems or components installed to perform, support or serve the activities and processes conducted in the building and which are classified for depreciation purposes as 3-year property, 5-year property, 7-year property, 10-year property or 15-year property by Section 168 of the Internal Revenue Code....

This regulation might support the Department’s arguments concerning depreciation—if it were a regulation intended to interpret or exemplify the meaning of “qualified equipment” in the Investment Credit Act. It is not. 3 NMAC 2.1.11.11, which is found under Section 7-9-3(C) NMSA 1978, interprets the term “construction” as used in the Gross Receipts and Compensating Tax Act. The first sentence of the regulation states: “*As used in Subsection C of Section 7-9-3, the noun “building” means....*” (emphasis added). There is no apparent reason—and none was provided by the Department—to rely on a regulation defining a “building” for purposes of the gross receipts tax to determine whether property is “qualified equipment” under the Investment Credit Act. This is particularly true when the Department has adopted separate regulations under the Investment Credit Act that specifically address which items of property qualify as equipment eligible for the credit.

Under the estoppel principles set out in Section 7-1-60 NMSA 1978, the Department is bound by its own regulations. Based on Regulations 3 NMAC 13.6.7, 3 NMAC 13.6.9 and 3 NMAC 13.6.9, as they existed at the time the Taxpayer's application for investment credit was filed, the Taxpayer is entitled to the investment credit on both the supplemental electrical system and the air conditioning units. Each item is a "machine, mechanism or tool" that is "used directly and exclusively in the plant" in which the Taxpayer's manufacturing activity takes place. Each item is depreciated on the Taxpayer's books and records and reflected as a depreciation expense on the Taxpayer's federal returns. With regard to these items, the Taxpayer has met the requirements set out in the pertinent regulations under the Investment Credit Act.

The Taxpayer is not entitled to the investment credit on the costs related to construction of the high bay area of the plant. This area does not meet the definition of "equipment" set out in Section 7-9A-3(B) or Regulation 3 NMAC 13.6.9. Unlike the electrical system and air conditioning units, the portion of the building constructed to house the enameling ovens is not a machine, mechanism or tool, or a component or fitting of a machine, mechanism or tool. The fact that the high bay area was designed solely to accommodate the enameling ovens required by the Taxpayer's manufacturing process is irrelevant. Only items of property that meet the definition of "equipment" under the pertinent statutes and regulations are eligible for the investment credit.

CONCLUSIONS OF LAW

1. The Taxpayer filed a timely, written protest to the Department's partial denial of the Taxpayer's application for investment credit, and jurisdiction lies over the parties and the subject matter of this protest.
2. The supplemental electrical system and air conditioning units meet the definition of qualified equipment set out in the applicable version of the Department's regulations under the

Investment Credit Act, and the Department is estopped from denying the Taxpayer the investment credit on the value of these items.

3. The high bay area of the Taxpayer's plant does not meet the definition of qualified equipment, and the Taxpayer is not entitled to the investment credit on any of the costs related to construction of this portion of the plant.

For the foregoing reasons, the Taxpayer's protest is granted in part and denied in part, and the Department is ordered to grant the Taxpayer's application for investment credit in accordance with Conclusion of Law No. 2, above.

DATED November 9, 2000.