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MEMORANDUM

To: Caglar Caglayan Date: August 19, 2003

From: Geoff Way

Subject: Cal Steel Implementation Guidance

The Board of Equalization modified its decision in the *Appeal of California Steel Industries, Inc.*, 2003-SBE-001-A, on July 9, 2003. In that decision, the Board defined which payments made to third-party contractors constitute capitalized labor costs that are qualified costs for purposes of the Manufacturers' Investment Credit (MIC). The purpose of this memo is to provide guidance to staff in the implementation of this decision.

The Department previously issued Legal Ruling 2000-1 (June 1, 2000) concerning third-party capitalized labor costs for the MIC. That ruling provided that, with respect to third-party contracts, the taxpayer was required to "look through" the contract and examine the relationship of the third-party contractor and employees working for that contractor. Under this approach, qualified costs for the MIC were limited to those costs of labor that constituted direct labor costs (as defined by Internal Revenue Code section 263A) on the basis of the payments made by the third-party contractor to its employees.

Due to the difficulty in obtaining this information, some language in examples in the Department's regulations and Legal Ruling 98-1 (February 2, 1998) that appeared to allow all third-party labor costs as qualified costs, the Board of Equalization in the *Cal Steel* decision rejected the Department's "look through" methodology. Instead, the Board concluded that all amounts paid to an independent contractor that constitute labor costs for the construction, modification or installation of qualified property are qualified costs for the MIC. Specifically, the Board stated:

Although we generally concur with appellant that its payments to an independent contractor constitute qualified costs, we do not believe amounts paid to an independent contractor attributable to non-labor costs constitute capitalized costs of labor for purposes of section 23649, subdivision (d)(3). **With respect to independent contractors, labor costs are all costs paid or incurred for services rendered in connection with the construction or modification of qualified property, including any overhead and profit attributable to such services.** For the union labor costs incurred by appellant, labor costs include all of the component costs that comprise the total wage rates under master labor agreements. **Non-labor costs are all other**

contract costs including, for example, materials, equipment purchases and/or rentals, small tools and consumables, and all other non-service charges and reimbursable costs, including overhead and profit attributable to such non-labor costs. If, however, a taxpayer can verify payment of sales or use tax on these items, then these non-labor costs may qualify under the general rule of section 23649, subdivision (b).

[Emphasis added.] (*Appeal of California Steel Industries, Inc.*, 2003-SBE-001-A, July 9, 2003, pp. 6-7.)

Accordingly, the *Cal Steel* decision distinguishes between labor and non-labor costs in a third-party construction contract. With respect to labor costs, only those costs that constitute labor costs paid for services rendered in connection with the construction or modification of qualified property constitute qualified costs for purposes of the MIC.

APPLICATION OF THE DECISION

It should be noted that this decision only applies to labor costs paid to third-party contractors. With respect to employee labor, the decision states:

Thus we do not find respondent's tax parity argument persuasive and believe respondent can properly apply the direct versus indirect labor cost differentiation to self-construction taxpayers, while not applying them to taxpayers hiring independent third-party contractors.

(*Appeal of California Steel Industries, Inc.*, 2003-SBE-001-A, July 9, 2003, pp. 5-6.)

The decision affirms that the taxpayers using employee labor for construction MIC assets may only claim direct costs of labor as defined in Internal Revenue Code section 263A and California Code of Regulations sections 23649-2, subdivision (b) and 23649-4, subdivision (d) as qualified costs for the MIC. Accordingly, for taxpayers claiming employee labor costs for the MIC, staff will need to obtain from the taxpayer a breakdown of the Internal Revenue Code section 263A direct and indirect costs of that labor and only direct costs of labor will constitute MIC qualified costs.

With respect to independent contractor (non-employee) labor, all labor costs as defined in the *Cal Steel* decision are allowed as qualified costs for the MIC. Labor costs are defined as all costs for services rendered in connection with the construction or modification of qualified property. Labor costs also include all of the contractor's overhead and profit associated with those labor costs. All non-labor costs are allowed as qualified costs only if they meet the general requirements for the MIC. To qualify for the MIC, non-labor costs must be: (1) paid in connection with the construction or modification of qualified property, (2) an amount upon which sales or use tax has been paid, and (3) an amount properly chargeable to the capital account of the taxpayer. Non-labor costs also include all of the contractor's overhead and profit associated with those non-labor costs.

To compute qualified costs with respect to third-party contracts, staff will generally need to identify three contract items: labor costs, non-labor costs and overhead and profit. First, identify all construction contracts associated with the item of qualified property. Next, determine which contracts contain detailed component cost information. For these contracts, separate the labor component from the non-labor component. Labor costs are all costs paid for services rendered in connection with the qualified property. These costs will include contract amounts for services to actually install, construct or modify qualified property, but can also include finder's fees, construction management fees or any other fees for personal services in connection with the construction activity.

With respect to each non-labor cost component, staff will need to determine if the cost meets the general rule for MIC qualified costs. Non-qualified costs for construction contracts are generally those non-labor costs upon which sales tax is not paid such as certain equipment rental charges, permit and other construction fees, construction drawing duplication costs, energy costs and other items where sales tax is generally not charged. Once all of these non-qualified costs are determined, staff must compute the percentage of non-qualified costs from the contract costs (excluding the amount of overhead and profit) and then apply this percentage to the overhead and profit. The total non-qualified non-labor costs and the corresponding portion of the overhead and profit represent the non-qualified costs from the contracts that contain detailed cost data.

The problem with third-party construction contracts is that some construction invoices contain no breakdown between labor and non-labor costs. For these invoices, the invoice description of the work performed should first be reviewed. If it is clear that the entire contract amount is for labor, or it appears that an insignificant amount of material was utilized (such as a plumbing or electrical invoice where a minor part or parts may have been included, but the majority of the cost was for services rendered), then the entire invoice amount should be allowed as a qualified cost. If it appears that a substantial amount of material or other costs were involved but not itemized, staff will need to issue an IDR to obtain the breakdown of the labor and non-labor contract costs including the total overhead and profit. Upon receipt of these amounts, staff can perform the analysis discussed above.

As with any other determination, staff will need to discuss with management the appropriate materiality thresholds for these invoices. For example, if the non-itemized invoices are small dollar invoices, it may not be advisable to expend the resources to obtain supporting documentation. However, if there are numerous small non-itemized invoices that represent the bulk of the construction costs for the asset at issue, then an itemization of the construction contract amounts must generally be obtained from the taxpayer. Staff will need to discuss these materiality issues with management as appropriate.

The determination of qualified costs with respect to third-party labor contracts has been a difficult issue for both taxpayers and the department. While the *Cal Steel* decision is contrary to published guidance issued by department staff, it does provide a workable definition for determining qualified costs that will streamline the examination process for both taxpayers and the department. The decision provides guidance that should reduce

the number of disputes concerning this issue and will allow more efficient use of department resources in the MIC examination process. An FTB Notice will be issued soon to withdraw Legal Ruling 2000-1 and FTB Notice 2002-1.