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FTB NOTICE 2002-1

MANUFACTURERS' INVESTMENT CREDIT (MIC) ALTERNATIVE COMPUTATION OF CAPITALIZED DIRECT LABOR COSTS UNDER THIRD-PARTY CONTRACTS

The Franchise Tax Board previously issued Legal Ruling 2000-1, dated June 1, 2000, regarding capitalized labor costs paid or incurred by a qualified taxpayer to a third-party contractor for the construction, modification or installation of qualified property. That ruling contains a detailed discussion of the general scope and application of Internal Revenue Code section 263A and the regulations thereunder. Legal Ruling 2000-1 held that with respect to the construction, modification or installation of qualified property, a taxpayer is required to look through a contract with a third-party contractor and only those amounts that are treated as capitalized direct costs of labor paid or incurred by the third-party contractor will in turn constitute capitalized direct costs of labor (qualified costs) for the taxpayer. Utilizing the precedent set in the uniform capitalization (UNICAP) allocation transition provisions in Temporary Treasury Regulation section 1.263A-1T(e)(6),¹ the purpose of this Notice is to provide an alternative computation provision with respect to third-party capitalized direct labor costs where a taxpayer has made a good faith effort but is unable to obtain direct labor cost data from a third-party contractor.

Taxpayers are encouraged to include in contracts for the construction of MIC qualified property a provision that the third-party contractor will provide the amount of or percentage of labor costs that constitute direct labor costs under Internal Revenue Code section 263A. As an alternative, where a taxpayer requests in writing the direct labor cost information from the contractor or otherwise makes a good faith effort to obtain the information and the third-party contractor does not provide the requested information, the taxpayer may compute the capitalized direct labor cost for the third-party contract as follows: (1) the taxpayer shall calculate the direct labor cost

¹ Under Internal Revenue Code section 263A and the regulations thereunder, taxpayers were required to change their method of accounting with respect to inventory property, effective for taxable years beginning after December 31, 1986. The change was to be made by revaluing the items or costs included in beginning inventory in the year of the change as if the new UNICAP rules had been in effect during all prior periods. Under certain circumstances where taxpayers lacked (and were not able to reconstruct from their books and records) actual financial and accounting data required to apply the UNICAP rules under section 263A, taxpayers were allowed to utilize actual data from substantially similar inventory and apply that data to the inventory for which actual data was not available. (See Temp.Treas. Reg. § 1.263A-1T(e)(6), Revaluation of Inventory, T.D. 8131, 52 F.R. 10052, March 30, 1987, adopted with minor modifications, Treas. Reg. § 1.263A-7(c), T.D. 8728, 62 F.R. 42051, August 4, 1997.)

percentage of the labor costs paid or incurred by the taxpayer to its own employees engaged in the qualified activity in which the qualified property constructed by the third-party contractor is placed in service, and (2) the taxpayer shall apply this percentage to the total labor costs (excluding overhead, profit and any other non-labor costs) paid or incurred to the third-party contractor to compute the capitalized labor costs that are eligible for the MIC.

For example, assume a taxpayer who was unable to obtain requested cost information from a third-party contractor paid \$100,000 in total labor costs to its employees engaged in the qualified activity where the qualified property is placed in service, and \$45,000 of those labor costs constitute direct costs under Internal Revenue Code section 263A. As a result, the taxpayer's direct labor cost percentage would be 45% ($\$45,000/\$100,000$). Assume further that the taxpayer paid a total of \$50,000 to the third-party contractor for labor costs (excluding overhead, profit and any other non-labor costs). Under the alternative computation methodology set forth in this Notice, the capitalized direct labor costs eligible for the MIC for the third-party contract costs would equal \$22,500 ($45\% \times \$50,000$).

For purposes of this alternative computation, the taxpayer shall utilize labor costs paid or incurred by the taxpayer to its employees for the taxable year in which the MIC is claimed for the qualified property that is constructed, modified or installed. Where taxpayers fail to obtain the information from third-party contractors and do not compute the alternative direct labor cost component utilizing their own employee information, Franchise Tax Board staff will continue to disallow all or a portion of the labor costs as qualified costs. Where appropriate, the Franchise Tax Board may impute a direct labor cost amount utilizing available industry labor cost data.

DRAFTING INFORMATION

The principal author of this notice is Geoff Way of the Franchise Tax Board, Legal Branch. For further information regarding this ruling, contact Mr. Way at the Franchise Tax Board, Legal Branch, P. O. Box 1720, Rancho Cordova, CA 95741-1720, and (916) 845-6351.