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TECHNICAL ADVICE MEMORANDUM 2011-01

Requested by: Alfredo Ramirez, on behalf of
Norman J. Scott, Director of National Business Audit Bureau

Requested Date: December 10, 2010

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Subject: Exclusion of Construction in Progress from the Property Factor Under
Regulation 25129(b)

QUESTION PRESENTED

1. Is real property listed as Construction in Progress (CIP) by a homebuilder/developer and used in the production of its business income included in the property factor?
2. If any portion of CIP is excluded:
 - a. Is it necessary to prove distortion for the excluded assets as an alternative method to recalculate the property factor?
 - b. Is there an alternative method to calculate the property factor to properly reflect California business activity?
 - c. Are there any items originally treated as CIP considered to be property held as reserve that is available for or capable of being used in regular trade or business? These items include:
 - i. Undeveloped and partially developed land with no actual or planned (within 2 years) development activities.
 - ii. undeveloped and partially developed land with development activities slated to begin within 2 years
 - iii. completed lots (purchased/prior to house construction)
 - iv. completed houses under sales contract
 - v. completed speculative houses
 - vi. completed model houses (used as models)
3. Assuming an alternative method to compute the property factor is identified and the taxpayer is not able to provide sufficient documentation, what alternatives do we have, if any, other than accepting a property factor computation without CIP?

CONCLUSIONS

Real property constituting Construction in Progress (CIP) of a homebuilder/developer must be excluded from the property factor because it is not regarded as property owned or rented and used in California during the taxable year under the plain language of the controlling regulation. Specified items such as land that have not yet become CIP or that may be treated as CIP at some point in the future, or that have been completed and are held for sale or other disposition, should be treated as property held as reserve that is available for or capable of being used in the taxpayer's regular trade or business or property that is no longer classifiable as CIP, and should be included in the property factor. For this purpose, property included in the property factor may be determined by the averaging of monthly values during the taxable year if reasonably required to reflect properly the average value of the taxpayer's property, particularly in circumstances where substantial fluctuations in the values of the property exist during the taxable year or where property is acquired after the beginning of the taxable year or disposed of before the end of the taxable year. Applying any other method to include CIP in the property factor would require the Department to prove distortion and an unfair reflection of the taxpayer's business activity in California, a showing that cannot be satisfied by merely establishing that including CIP in the property factor would result in a different tax burden from one that would be imposed if the CIP is excluded from the property factor. Different rules apply in cases in which the taxpayer is a contractor using the percentage of completion method of accounting, or the completed contract method of accounting for long-term contracts.

ANALYSIS AND DISCUSSION

Guidance has been sought as to whether real property listed as Construction in Progress (CIP) by a homebuilder/developer and ultimately used in the production of its business income should properly be included in the homebuilder/developer's property factor.

Homebuilder/developers ordinarily engage in the purchase and development of land or lots and the construction and sales of single-family homes, townhomes, and low-rise condominiums. They have often participated in the conventional homebuilding business for a number of years. Their practice has been to acquire land, build homes on the land, and sell the homes within a certain period of time from the date of acquisition, a timeframe that can often exceed the reasonable national average for construction times (*i.e.*, 150 days for single-family homes and 240 days for multi-family buildings). Generally, the activities of these homebuilder/developers involve acquiring land that is properly zoned and is either ready for development or, to some degree already developed. Revenue from home building projects and investment real estate is recognized when homes and properties are sold and title passes.

Generally, the first step in this residential development process is to identify the geographic area, based upon potential demand, where a community will be built and then to acquire the land, either through an outright purchase, acquiring an option or options to purchase, or a combination of both. Options may be conditioned upon the builder/developer obtaining the necessary permits for the project. An additional step is the process of land planning, which may involve development of a master plan for the land and the governmental permitting process, together with securing any necessary changes to zoning density and/or use.

After obtaining ownership and the necessary permits, the land usually must be subdivided. If so, the land must be cleared, graded, and subdivided into lots. In some developments, substantial environmental remediation may be required to be performed before the land is suitable for development (such as is commonly found when former U.S. military bases are being developed).

A major component of the residential development process often is the construction and installation of the infrastructure, or common improvements, for the planned community. Common improvements may include bridges, interchanges, streets, sidewalks, sewage and drainage lines, utility lines, street lights, retaining walls, and landscaping. Community facilities may also be constructed by the builder/developer such as clubhouses, recreational centers, community pools, tennis courts, parks, schools, libraries, and playgrounds.

Builder/developers must attract prospective buyers for their homes. One of the ways to attract customers is to include in the community amenities such as those described above. Another way to attract customers is to construct model homes. Typical model homes are constructed and furnished to allow potential buyers to walk through an actual home to see its features. The model home centers are usually staffed by the builder/developer's personnel, who provide information and assist potential buyers in selecting a home.

Ordinarily, the builder/developer and a potential purchaser enter into a sales contract once the customer has decided to buy a home. The contract establishes the particular type of home to be built, the location of the home site, any additional features and the terms of the deposit. Based upon the specifications in the sales contract, the builder/developer constructs the home using unrelated subcontractors. The subcontractors are paid by the builder/developer, who is responsible for construction financing. After the home receives a certificate of occupancy (or similar documentation) from the applicable building department, an escrow closing is scheduled with the buyer. At closing, title to the residence passes from the taxpayer to the buyer and all necessary paperwork is completed and signed. For financial accounting purposes the earnings process is complete and the net profit from the sale of the home is generally recognized in the taxpayer's financial statements at the time of closing.

The general rule for inclusion of property in the property factor is set out in California Revenue and Taxation Code section 25129, which provides that "The property factor is a fraction, the numerator of which is the average value of the taxpayer's real and tangible personal property owned or rented and used in this state during the taxable year and the denominator of which is the average value of all the taxpayer's real and tangible personal property owned or rented and used during the taxable year."

Regulation 25129(a) provides clarification of how the general rule for inclusion of property in the property factor should be applied:

The property factor of the apportionment formula for each trade or business of the taxpayer shall include all real and tangible personal property owned or rented by the taxpayer and used during the income year in the regular course of such trade or business. The term "real and tangible personal property" includes land, buildings,

machinery, stocks of goods, equipment, and other real and tangible personal property but does not include coin or currency.

Property used in connection with the production of nonbusiness income shall be excluded from the property factor. Property used both in the regular course of taxpayer's trade or business and in the production of nonbusiness income shall be included in the factor only to the extent the property is used in the regular course of taxpayer's trade or business. The method of determining that portion of the value to be included in the factor will depend upon the facts of each case.

The property factor shall reflect the average value of property includible in the factor. See Regulation 25131.

Thus, to be included in the property factor, the property must be both owned or rented by the taxpayer, on the one hand, and used during the taxable year in the regular course of the trade or business of the taxpayer, on the other. Guidance for what constitutes being used in the taxable year in the regular course of the taxpayer's trade or business is provided by Regulation 25129(b):

Property shall be included in the property factor if it is actually used or is available for or capable of being used during the income year in the regular course of the trade or business of the taxpayer. Property held as reserves or standby facilities or property held as a reserve source of materials shall be included in the factor. For example, a plant temporarily idle or raw material reserves not currently being processed are includible in the factor. Property or equipment under construction during the income year (except inventorable goods in process) shall be excluded from the factor until such property is actually used in the regular course of the trade or business of the taxpayer. If the property is partially used in the regular course of the trade or business of the taxpayer while under construction, the value of the property to the extent used shall be included in the property factor. Property used in the regular course of the trade or business of the taxpayer shall remain in the property factor until its permanent withdrawal is established by an identifiable event such as its conversion to the production of nonbusiness income, its sale, or the lapse of an extended period of time (normally, five years) during which the property is held for sale.

The first sentence of the Regulation repeats the general rule that property should be included in the property factor if it is actually used or is available for or capable of being used during the taxable year in the regular course of the trade or business of the taxpayer. The following sentences clarify *when* property is deemed to be actually used or is available for or capable of being used during the taxable year in the regular course of the trade or business of the taxpayer. Thus, the second sentence provides that property held as reserves or standby facilities or property held as a reserve source of materials must be included in the property factor, and the third sentence provides an example of a plant temporarily idle or raw material reserves not currently being processed as property that should be included in the property factor. Next, the Regulation explicitly states that "Property or equipment under construction during the income year (except inventorable goods in process) shall be excluded from the factor until such property is

actually used in the regular course of the trade or business of the taxpayer." As used in a statutory or regulatory context, "shall" means "must." Furthermore, the clear conclusion to be drawn from a fair reading of the plain meaning of the quoted sentence is that property under construction is *not* property that is actually *used or that is available for or capable of being used* during the taxable year in the regular course of the trade or business of the taxpayer as required by Revenue and Taxation Code section 25129 for inclusion of that property in the property factor. A fair reading of the plain meaning of the quoted sentence also leads to the conclusion that construction in process must be excluded from the property factor *until* such time as the property is actually used in the regular course of the trade or business of the taxpayer; because phrased in terms of an exclusion from the property factor "until . . . actually used in the regular course of the trade or business," the clear implication is that construction in process is not currently being used in the trade or business, and thus it cannot be honestly argued that construction in process should be included in the property factor because it is crucial to the taxpayer's business and therefore is actually being currently used in the trade or business however it is classified.¹

Regardless of whether this result may or may not have been actually intended by the original drafters of the Regulation, applicable principles of statutory construction are well settled and apply equally to regulations drafted by agency personnel. Courts attempting to construe statutes (or regulations) will attempt to determine and effectuate legislative (or regulatory) intent by looking first to the words of the statute or regulation (*Woods v. Young* (1991) 53 Cal.3d 315, 323), "giving them their usual and ordinary meaning." (*Da Fonte v. Up-Right, Inc.* (1992) 2 Cal.4th 593, 601.) The words of the statute or regulation are examined and given a plain and commonsense meaning; if the language is clear and unambiguous there is no need for construction or for an examination of extrinsic evidence of legislative or agency intent. (*Lungren v. Deukmejian* (1988) 45 Cal.3d 727, 735.) If there is no ambiguity in the language of the statute or regulation, "then the Legislature [or regulatory agency] is presumed to have meant what it said, and the plain meaning of the language governs." (*Kizer v. Hanna* (1989) 48 Cal.3d 1, 8.) "Where the statute [or regulation] is clear, courts will not 'interpret away clear language in favor of an ambiguity that does not exist.' [Citation.]" (*Hartford Fire Ins. Co. v. Macri* (1992) 4 Cal.4th 318, 326.) Where there is a conflict between a specific regulation and a general one, the specific one controls. (*Lusardi Construction Co. v. California Occupational Safety & Health Appeals Bd.* (1991) 1 Cal.App.4th 639.) Additionally, whenever possible, every word and clause of a statute or regulation must be given effect so that no part or provision will be useless or meaningless, and none of its language rendered surplusage. (*Briggs v. Eden Council for Hope & Opportunity* (1999) 19 Cal.4th 1106, 1118.) Like a statute, a regulation is presumed valid (*Yamaha Corp. of America v. State Bd. of Equalization* (1998) 19 Cal.4th 1) and, if anything, regulatory language (as opposed to statutory) is more likely to be construed against the regulatory agency in any case of doubt or where interpretation of the meaning is deemed to be necessary because agency

¹ The argument here is that homes under construction are a vital part of the homebuilder's business. Through continuous building of homes, the homebuilder is able to assure that it can meet its customer's demand for its homes. This adds to business' overall ability to generate income. Furthermore, in a large percentage of transactions, the home builder had entered into a sales agreement with the home buyer prior to the completion of the home. Although title could not be transferred and the home builder could not receive payment prior to completion of the house, the expected future revenue was certainly advantageous to the business. For these reasons, construction in process is "actually used in the regular course of the trade or business" even though it does not generate current income.

personnel are held to be expert and knowledgeable in the area of the law they are charged with regulating. Finally, to the extent statutory or regulatory language might be construed as ambiguous, California courts have generally favored the interpretation favoring the taxpayer; as a general rule all tax legislation must be construed strictly against the state and most favorably to the taxpayer. (*Microsoft Corp. v. Franchise Tax Bd.* (2006) 39 Cal.4th 750, 759, citing *Edison California Stores, Inc. v. McColgan* (1947) 30 Cal.2d 472, 476; cf. *Riley v. Havens* (1924) 193 Cal. 432; *In re Estate of Parrott* (1926) 199 Cal. 107; *Golden Gate Bridge & Highway Dist. v. Felt* (1931) 214 Cal. 308, 326.)

Accordingly, construction in process must not be included in the property factor until the underlying property is actually "used" in the trade or business. Presumably, because it cannot be included while it is construction in process, this means property can only be included before construction is begun (in the case of land) and/or after construction is complete.² The only possible exception to this exclusion for property under construction, or construction in process, is for "inventoriable goods in process."³ However, under the federal definition (IRC §§ 471, 472) as incorporated in California law (Rev. & Tax. Code §§ 24701, 25130) inventoriable goods in process do not include real property. Land and houses under construction are real property, not goods. (See *W.C. & A.N. Miller Development Co. v. Comm'r*, (1983) 81 T.C. 619 (real property, whether in the form of land or buildings, is not inventory within the meaning of IRC section 472);

² Those cases from other jurisdictions that might be read as reaching a seemingly contrary result can be distinguished either on their facts or on the underlying law the court was attempting to apply. (E.g., *Crown Enterprises, Inc. v. Woods* (Tenn. 1977) 557 S.W.2d 491 (CIP is used in a homebuilder's construction business, but the court was addressing the question of whether the imposition of a franchise tax was proper because the construction was part of the capital employed in doing the corporate business in Tennessee and thus represents a part of the measure of the use of the corporate franchise, rather than whether such property should be included in the property factor); *State Dept. of Revenue v. Amoco Production Co.* (Alaska 1984) 676 P.2d 595 (oil company's nonproducing oil and gas leases—not the construction in process of a homebuilder/developer—constitute property "used" in the state within the meaning of UDITPA's property factor); *Commissioner of Revenue v. New England Power Co.* (Mass. 1991) 582 N.E.2d 543 (construction work in progress properties developed by NEP did not produce income as a result of producing energy, but their existence nevertheless contributed to its overall revenue production in the context of special utility regulation because of fact FERC considered the amounts of construction work in progress in setting the taxpayer's rates and reduction in tariffs amounted to an indirect generation of income; term "used" in governing regulation should not be defined with reference to a Multistate Tax Commission regulation (as in California) where the Legislature has declined to adopt the Commission's definition despite a recommendation to do so). Cf. *Donald M. Drake Co.*, 77-SBE-012, Feb. 3, 1977, modified by 77-SBE-013, March 2, 1977 (taxpayer participated in long-term construction projects as a joint venture, where joint ventures had adopted the completed-contract method of accounting, declining to follow special rules contained in Franchise Tax Guideline Letter Number 1064 [later codified at Regulation 25137-2] instructing contractors how to apportion income when one or more of their construction projects is on the completed-contract method of accounting); *Appeal of the O.K. Earl Corp.*, 77-SBE-051, April 6, 1977 (similar; special rule under Regulation 25137 applied.)

³ It is a general rule of statutory construction that if a statute specifies exceptions to its general application, other exceptions not explicitly mentioned are excluded. Under the maxim expression *unius est exclusio alterius*, that is, the expression of certain things in a statute necessarily involves exclusion of other things not expressed, the enumeration of acts, things, or persons as coming within the operation or exception of a statute will preclude inclusion by implication in the class covered or excepted of other acts, things, or persons. Under this rule, if a statute contains an express exception or exceptions, it will be presumed that no other exceptions were intended. The same rule applies for regulations. (Cal. Jur. 3d, Statutes, § 129, p. 550; *Myers v. Stevenson* (1954) 125 Cal.App.2d 719, 731; *Sterling Drug, Inc. v. Benatar* (1950) 99 Cal.App.2d 393, 397-398; *Rothschild v. Superior Court* (1930) 109 Cal.App. 345, 348.)

see also Black's Law Dict. (8th ed. 2004) p. 714, col.2 (defining "goods" as "tangible or movable personal property other than money.")

Property that can be included in the property factor because it is owned or rented and used in California during the taxable year, and therefore not excluded because it is construction in process, or that can be regarded in the nature of property held as reserves or standby facilities or property held as a reserve source of materials (see Cal. Code Regs., tit. 18, 25129(b)) could include: undeveloped and partially developed land, regardless of whether development activities for that land are actual or planned, and regardless of whether any planned are actual activities would or could take place within any set timeframe such as one or two years; completed lots purchased prior to house construction; completed houses under sales contract; completed speculative houses; completed model houses, whether used as models and/or available for sale; and completed community improvements such as parks, libraries, clubhouses, community centers, parkways, etc. Because all such property is property that is owned or rented and used in California during the taxable year (see Cal. Rev. & Tax. Code § 25129), it should be included in the property factor until such time as "its permanent withdrawal is established by an identifiable event such as its conversion to the production of nonbusiness income, its sale, or the lapse of an extended period of time (normally five years) during which the property is held for sale." (Cal. Code Regs., tit. 18, 25129(b).)

Regulation 25129(a) provides that the property factor must reflect the average value of property includible in the factor. Revenue and Taxation Code section 25131 provides that "The average value of property shall be determined by averaging the values at the beginning and ending of the taxable year but the Franchise Tax Board may require the averaging of monthly values during the taxable year if reasonably required to reflect properly the average value of the taxpayer's property." An appropriate circumstance for requiring averaging of monthly values during the taxable year is specifically provided in Regulation 25131: "Averaging by monthly values will generally be applied if substantial fluctuations in the values of the property exist during the income year or where property is acquired after the beginning of the income year or disposed of before the end of the income year." The type of property being considered in this Technical Advice Memorandum, i.e., property described in the above paragraph as property that cannot be excluded because it is construction in process, would seem to be the type of property contemplated for the averaging of monthly values during the taxable year. The necessity of using an approach to determine the property factor by averaging monthly values may be revealed by conducting an initial check that uses a ratio of the total value of California homes sold to the total value of homes sold everywhere during the tax year, but the inherent nature of the homebuilder/developer business is such that averaging monthly values of non-CIP will probably be required to get a true picture of the taxpayer's California business activity. It would also seem to be appropriate to allow the auditor to make monthly estimates if the taxpayer seeks to exclude construction in progress from the property factor but fails or refuses to provide this information, on the rationale that this is necessary because the taxpayer has failed to bear its burden of proof and/or substantiate its filing position.

The required exclusion of CIP from the property factor discussed above does not apply for taxpayers who elect to use the percentage of completion method of accounting or the completed

contract method of accounting for long-term contracts. Regulation 25137-2⁴ sets forth special apportionment rules for these taxpayers, providing in pertinent part, that:

(a) When a taxpayer elects to use the percentage of completion method of accounting, or the completed contract method of accounting for long-term contracts, as provided by Revenue and Taxation Code section 24673.2, and has income from sources both within and without this state, the amount of business income derived from sources within this state, including income from such long-term contracts, shall be determined pursuant to these regulations.

....

(d)(3) Completed Contract Method.... In general, under this method of accounting, business income derived from long-term contracts is reported for the taxable year in which the contract is finally completed and accepted. Therefore, a special computation that apportions the income using the apportionment percentages for the years in which the contract was performed is required to compute the amount of business income attributable to this state from each completed contract. (See subsection (e) of this regulation.) Business income from all other activities not related to long term contracts subject to the completed contract method of accounting is then apportioned to this state using the regular three or four factor apportionment formula provided by Revenue and Taxation Code section 25128. The apportionment percentages used for apportioning the income from other activities (income not attributable to completed long term contracts) is computed as provided in subsections (4), (5) and (6) of this regulation for each of the taxable years in which such other income is recognized.

(d)(4) Property Factor. In general the numerator and denominator of the property factor shall be determined as set forth in Revenue and Taxation Code sections 25129, 25130 and 25131 and the regulations thereunder. However, the following special rules are also applicable when either the completed contract or percentage of completion method of long term contract accounting is used:

(A) The average value of the taxpayer's cost (including materials and labor) of work in progress, to the extent such costs exceed progress billing . . . shall be included in the denominator of the property factor. The value of any such costs attributable to projects in this state shall be included in the numerator of the property factor.

Taxpayers are entitled to rely on the Department's regulations, and the Department is bound to apply them. (*Appeal of Union Carbide Corp.*, 84-SBE-057, April 5, 1984.)⁵ Thus, if a party wishes

⁴ First adopted in 1974, Regulation 25137-2 codified the FTB 1967 Guideline Letter Number 1064, Application of the Uniform Division of Income for Tax Purposes Act to Construction Contractors. The regulation was amended in 2002 to apply the special apportionment rules to all taxpayers, not just construction contractors, who elect to use the percentage of completion method of accounting or the completed contract method of accounting for long-term contracts.

to depart from a UDITPA regulation, where the regulation applies by its terms, that party must prove the existence of distortion. (*Appeal of Fluor Corp.*, 95-SBE-016, Dec. 12, 1995.) Proving distortion requires a qualitative analysis of the relationship between the apportionment formula and the taxpayer's business activities (*Appeal of Crisa Corp.*, 2002-SBE-004, June 20, 2002), as well as a quantitative analysis of the alleged resulting distortion. Deviation from the apportionment formula is not authorized merely because a party has presented a "better" or more "reasonable" approach—the party wishing to deviate from the formula must demonstrate distortion. (*Appeal of New York Football Giants, Inc.*, 77-SBE-015, June 28, 1979.) The California Supreme Court has stated that the party invoking that section has the burden of proving by clear and convincing evidence that: (1) the approximation provided by the standard formula is not a fair representation of the taxpayer's business activity in California; and (2) its proposed alternative is reasonable. (*Microsoft Corp. v. Franchise Tax Bd.*, *supra*, 39 Cal.4th at p. 765.) It is unknown what circumstances would have to exist that are sufficiently different from those given in this Technical Advice Memorandum in the context of homebuilder/developers and CIP, given the plain reading of the pertinent regulation, where the Department could prove by clear and convincing evidence that the approximation provided by the standard formula is not a fair representation of the taxpayer's business activity in California and that the proposed alternative is reasonable, but it is theoretically possible. Further guidance would have to be given should the auditor believe that the individual facts presented by a particular taxpayer are unusual enough so as to allow the Department to meet this burden and apply an alternative apportionment method that would include construction in process in the property factor.

⁵ Shortly after *Union Carbide*, the Board reached an apparently inconsistent conclusion in the *Appeal of Triangle Publications*, 84-SBE-096, June 27, 1984 (*Triangle Publications*). In *Triangle Publications*, the Board held that, to the extent a UDITPA regulation conflicts with the standard apportionment formula, the regulation is applicable only upon a showing of distortion in the standard formula. However, in *Appeal of Fluor Corporation*, 95-SBE-016, December 12, 1995, the Board expressly overruled that portion of *Triangle Publications*.