2003-SBE-001-A

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of	)	
	)	No. 160703
California Steel Industries, Inc.	)	
	)	

Representing the Parties:

For Appellant:	Douglas Bramhall Chris Micheli, Esq.
For Respondent:	Michael J. Cataldo, Tax Counsel III
Counsel for Board of Equalization:	Reed Schreiter, Tax Counsel

O P I N I O N ON PETITION FOR REHEARING

Upon consideration of the petition for rehearing filed by respondent, we hereby restate and amend our original opinion as indicated below. In its petition, respondent requests the Board to provide clarification regarding the meaning of capitalized labor costs in the context of third party (independent) contractors. We believe clarification of our original opinion is warranted; in all other aspects, our original opinion remains the same. Therefore, in amending our opinion, we hereby withdraw our previous opinion in this appeal, dated January 9, 2003, and replace it with this opinion. We deny respondent's petition for rehearing because the arguments set forth in the petition do not constitute sufficient grounds to grant a rehearing. (See *Appeal of Wilson Development, Inc.,* 94-SBE-007, Oct. 5, 1994.)

This appeal is made pursuant to section 19045[1] of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of California Steel Industries,

[1] Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the income years in issue.

Inc., against a proposed assessment of additional franchise tax in the amount of $901,729.40 for the year ended December 31, 1995, and the amount of $13,055.36 for the year ended December 31, 1996. The issue presented by this appeal is whether appellant's payments to an independent contractor for construction of qualified property represent "capitalized labor costs that are directly allocable to the construction" of qualified property, and thus constitute qualified costs for purposes of the Manufacturers' Investment Credit (MIC).

Appellant, a California corporation headquartered in Fontana, California, manufactures steel and steel products. Appellant purchased the Fontana manufacturing facilities of Kaiser Steel in 1984. In 1992, appellant instituted repairs to, and upgrades of, the facilities. Appellant entered into numerous cost-plus construction contracts with various contractors for purposes of effecting the desired improvements. During 1994, 1995, and 1996, appellant claimed the MIC on 83 improvement projects. The largest project involved construction of a 62-inch "pickle line" used in the production of hot rolled steel.[2] Due to its size, the pickle line sits on a base that absorbs the weight, dampens the vibrations, and facilitates the processes of the machinery, as well as provides earthquake safety protection. Appellant capitalized the costs of constructing the pickle line as they were paid.

Two of the independent contractors working on the construction projects submitted information to appellant categorizing various costs comprising the contract payments made by appellant, while the remainder of the contractors did not provide such categorization. The information provided identified the direct labor costs (i.e., basic compensation, overtime pay, vacation pay, holiday pay, sick leave pay, shift differential, payroll taxes, and payments to supplemental unemployment benefit plans associated with particular units of specific property produced) and the indirect labor costs (labor costs not directly associated with particular units of specific property) incurred on the project. For purposes of its California tax returns, appellant capitalized the entire amounts paid to the various independent contractors and claimed such amounts as qualified costs under the MIC. On its 1995 tax return (which included costs incurred in 1994 and 1995), appellant claimed costs of $52,554,367 as qualifying for the MIC; appellant claimed MIC qualifying costs of $2,338,317 on its 1996 tax return.

On audit, respondent disallowed costs of $20,999,554 for 1995 and $217,583 for 1996. Respondent agreed appellant was a qualified taxpayer and that much of the property was qualified property. Respondent, however, did not allow the entire costs paid to the independent contractors as qualified costs. Respondent, instead, concluded appellant must allocate the total costs paid to the independent contractors between direct labor costs and indirect labor costs

[2] A "pickle line" removes surface impurities from hot rolled coiled steel via a wash and rinse process utilizing an acid solution. Apparently, a "pickle line" is not one individual piece of equipment, but consists of equipment occupying approximately 100,000 square feet of floor space in the "Tin Mill Building," is three stories high, and operates 24 hours a day processing steel coils weighing up to 40 tons.

pursuant to California Code of Regulations, title 18 (Regulation), section 23649-2, subdivision (b). At protest, respondent made adjustments to its original determination and reduced its original assessment for 1995 by $358,245.00, leaving $901,729.40 at issue for 1995 and $13,055.56 at issue for 1996. Appellant timely appealed to this Board.

The MIC provides an income tax credit to any qualified taxpayer for specified qualified costs paid or incurred on or after January 1, 1994, for qualified property placed into service in this state. (Rev. & Tax. Code, § 23649, subd. (a)(1); Cal. Code Regs., tit. 18, § 23649-1, subd. (a).)[3] Qualified cost means any cost paid or incurred by a qualified taxpayer for the construction, reconstruction, or acquisition of qualified property after January 1, 1994, upon which the taxpayer has paid sales or use tax, except as provided in section 23649, subdivision (d)(3); and, the cost is properly chargeable to the taxpayer's capital account. (Rev. & Tax. Code, § 23649, subd. (b)(1).) Section 23649, subdivision (d)(3), provides that qualified property includes the "value of any capitalized labor costs that are directly allocable to the construction or modification" of qualified property; it is this provision relating to qualified costs that is at issue in the current appeal.

When promulgating the regulations to accompany the "qualified cost" provisions within section 23649, specifically, the "capitalized labor cost" provision, respondent incorporated the uniform capitalization rules found in Internal Revenue Code (IRC) section 263A and Treasury Regulation section 1.263A-1(e)(2) and (3) regarding capitalization of labor costs. As a result, if labor costs are properly treated pursuant to IRC section 263A (as direct costs of labor capitalized to an item of property produced by the taxpayer), then the costs are also treated as direct labor costs under the MIC. To this end, Regulation section 23649-2, subdivision (b), provides that " 'capitalized labor' shall mean all direct costs of labor that can be identified or associated with and are properly allocable to the construction, modification, or installation of specific items of qualified property." (See, *e.g.,* Treas. Reg. § 1.263A-1(e)(2).) Further, the regulation provides that the term "labor" includes independent contractors. Regulation section 23649-2, subdivision (b)(1), defines "direct labor costs" to include all elements of compensation, including basic compensation, overtime pay, vacation pay, holiday pay, specified sick leave pay, shift differential, payroll taxes, and payments to supplemental unemployment benefit plans, but not indirect labor costs. (See, *e.g.,* Treas. Reg. § 1.263A-1(e)(2).) Regulation section 23649-2, subdivision (b)(2), defines "indirect labor costs" as "costs that cannot be identified or associated with construction, modification, or installation of specific items of qualified property" and includes training costs, officers' compensation, pension and other related costs, and specified employee benefit expenses. (See, *e.g.,* Treas. Reg. § 1.263A-1(e)(3).)

[3] Section 17053.49, and the accompanying regulations, set forth similar provisions in the Personal Income Tax Law, including identical definitions of "qualified costs" and "qualified property." Our discussion thus also appears to apply to those provisions.

Respondent issued Legal Ruling 98-1, Legal Ruling 2000-1, and FTB Notice 2002-1, all of which address capitalization of labor costs under the MIC. Legal Ruling 98-1 (Manufacturers' Investment Credit Capitalized Costs of Labor for Engineering and Design) discusses capitalization of labor costs incurred by a qualified taxpayer for engineering and design services performed both in-house and by an independent contractor. Legal Ruling 2000-1 (Manufacturers' Investment Credit Capitalized Costs Under Third-Party Contracts) again discusses capitalization of labor costs incurred by a qualified taxpayer for work performed by a third-party contractor. In this legal ruling, respondent clarifies the "look through" doctrine. Finally, FTB Notice 2002-1 sets forth alternative procedures for taxpayers in determining the proper allocation of direct labor costs and indirect labor costs if a taxpayer failed to obtain the information from an independent contractor sufficient to apply the "look through" doctrine. In such an instance, the taxpayer could utilize either an industry standard percentage allocation between direct and indirect labor costs or the percentage allocation between direct and indirect labor costs of its own employees engaged in appropriate activities.

Appellant presents a simple argument in favor of its position. Appellant contends it engaged various independent contractors to construct a 62-inch "pickle line," and other specific items of qualified property. As the independent contractors completed work on the qualified property, appellant paid contractually specified sums to the independent contractors, and capitalized such payments. Thus, appellant contends, all payments to the independent contractors represented capitalized labor costs directly allocable to the construction of a specific item or items of qualified property and qualify under the MIC. Appellant cites respondent's Legal Ruling 98-1, Regulation sections 23649-2, subdivision (b), and 23649-4, subdivision (d), the language of section 23649, subdivisions (b)(1) and (d)(3), and IRC section 263A in support of its position. Appellant also asserts Regulation section 23649-4, subdivision (d), and Legal Ruling 98-1 are consistent with each other, whereas Legal Ruling 2000-1 directly conflicts with Regulation section 23649-4, subdivision (d), and in particular, Example 3 in that Regulation section.

Appellant also contends respondent erroneously disallowed miscellaneous costs for items such as rental equipment, materials, and other miscellaneous costs because appellant failed to show that sales tax was paid on these items. Appellant, however, contends it paid the independent contractor for the independent contractor's labor, whether the labor was incurred in operating its own equipment or applying materials needed to complete the project. Thus, all the costs were direct costs of labor. With respect to documenting its claimed costs, appellant contends that, although the documentation required by respondent is onerous, it does adequately substantiate the various claimed costs. To the extent any costs remain unsubstantiated (appellant indicates approximately 92 percent of its costs are adequately substantiated), appellant asserts the rule from *Cohan v. Commissioner* (2nd Cir. 1930) 39 F.2d 540, supports a conclusion that appellant provided adequate documentation for all claimed costs.

Respondent argues that appellant's position, specifically, to allow the entire amount paid to an independent contractor as a direct labor cost allocable to a specific item of qualified property, ignores the approach adopted by respondent from Treasury Regulation section 1.263A-1(e). In particular, respondent contends the federal regulations, and thus the California regulations, refer to independent contractors in the definitions of both direct labor and indirect labor. As a result, respondent alleges, all payments to an independent contractor cannot necessarily be direct labor costs. To the contrary, a portion of the payment to an independent contractor necessarily includes employee benefit costs, which are excluded from the definition of direct labor costs, and thus are not qualified under the MIC.

Respondent further contends the labor costs associated with workers' compensation and fringe benefits, as well as the additional costs identified by the independent contractors for small tools and consumables, overhead, and profit are clearly not direct labor costs or costs on which sales tax has been paid and cannot be allowed. Respondent alleges appellant seeks to obtain the MIC indirectly on costs it could not qualify for if it incurred such costs.

Respondent asserts that if this Board adopts appellant's position, taxpayers who self-construct qualified property will be treated differently than taxpayers who hire independent contractors to construct qualified property because the self-constructing taxpayer cannot claim indirect labor costs under the MIC. Respondent believes this result is contrary to the MIC statute and sound tax administration policy.

Upon review of the language of section 23649, subdivisions (b)(1) and (d)(3), Regulation sections 23649-2, subdivision (b), and 23649-4, subdivision (d), Legal Ruling 98-1, and IRC section 263A, we agree with much, but not all, of appellant's argument. Initially, as we have previously stated, underlying our approach to the MIC is our belief that the MIC should be interpreted liberally in favor of taxpayers. (*Appeal of Save Mart Supermarkets & Subsidiary,* 2002-SBE-002, Feb. 6, 2002.) As a starting point, we disagree with respondent's contention that a self-constructing taxpayer and a taxpayer hiring an independent contractor are similarly situated with respect to construction of qualified property. The very fact that one taxpayer maintains employees to design and/or construct qualified property distinguishes that taxpayer from another taxpayer which does not, cannot, or will not incur the ongoing costs of maintaining employees to design and/or construct qualified property. 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-constructing taxpayers, while not applying them to taxpayers hiring independent third-party contractors.

We further find respondent's approach ignores business reality with respect to a taxpayer's hiring of an independent contractor. First, as argued by appellant, a taxpayer is not concerned with how an independent contractor categorizes various costs of a project as long as

the costs to the taxpayer are justified, reasonable, and represent the best value to the taxpayer. Second, respondent's approach imposes a potentially impractical burden on taxpayers to obtain detailed labor cost information from independent contractors. In particular, some independent contractors may not wish to divulge such information, others may not keep accurate records of such information, while others may increase the costs of the project to reflect the additional service provided. We do not believe this result to be appropriate tax policy.

Finally, as argued by appellant, a taxpayer which hires and pays an independent contractor for construction of qualified property may correctly attribute the amounts paid to the independent contractor to the specific items of qualified property; thus satisfying the requirements for qualified costs. We find support for this view in respondent's Legal Ruling 98-1. In respondent's analysis of Situation 1 of the legal ruling, respondent states:

> "Only capitalized direct costs of labor may be qualified costs for purposes of the MIC. The test for whether costs of labor are direct costs of labor under I.R.C. § 263A is whether these costs 'can be identified or associated with particular units or groups of units of specified property.' (Treas. Reg. § 1.263A-1(e)(2)(B); Cal. Code. Regs., tit. 18, §§ 17053.49-2(c) and 23649-2(c).) The engineering and design costs represented by X's payments to the independent third party contractor, Y, would be properly treated as direct costs of labor capitalized to an item of property pursuant to I.R.C. § 263A under X's normal method of accounting because they are identified and associated with the new coker."

In the current appeal, the record suggests appellant can identify or associate the costs paid to the independent contractor for labor with particular units or groups of units of specified property. Thus, appellant meets the criteria set forth in the legal ruling. The language of the legal ruling also comports with Regulation section 23649-4, subdivision (d), Example 3, in which respondent allows that a qualified taxpayer may include in qualified costs the cost of modifying qualified property since the payment to the independent contractor is "properly treated as a capitalized labor cost that is directly allocable to the modification of qualified property."

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).

Finally, appellant cites *Cohan v. Commissioner, supra*, 39 F.2d 540, to support its argument that substantiating 92 percent of its claimed costs is sufficient for respondent to proceed as if adequate documentation has been provided for the remaining costs. This Board discussed the "*Cohan* Rule" in the *Appeal of Henrietta Swimmer, Executrix*, *et. al.* (63-SBE-138), decided on December 10, 1963:

> "[T]he *Cohan* rule merely permitted the deduction of a reasonable portion of unsubstantiated expenses. Here only a portion of appellant's deductions have been disallowed. Generally speaking, respondent permitted appellant to deduct 50 percent of the amounts he was unable to substantiate. Where the respondent has allowed part of a deduction, we will not alter its determination unless facts appear from which a different approximation can be made."

Our prior discussion of the *Cohan* Rule indicates our reluctance to disturb respondent's determinations involving unsubstantiated amounts without independent facts on which to base a different finding. Given no independent facts have been provided to us, we refuse to alter respondent's determination regarding unsubstantiated costs.

In conclusion, a taxpayer which hires and pays an independent contractor for construction of qualified property and which can attribute the labor costs paid to the independent contractor with particular units or groups of units of specified property, may claim the amounts paid to the independent contractor for labor costs as qualified costs. We do not conclude, however, that amounts paid to an independent contractor attributable to non-labor costs, such as 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 constitute capitalized costs of labor for purposes of section 23649, subdivision (d)(3). If a taxpayer can verify payment of sales or use tax on these items, then these costs may qualify under section 23649, subdivision (b). Therefore, in the present case, appellant may take the MIC amount for payments to the independent contractor for labor costs as defined herein, but may not include unsubstantiated costs.

We deny respondent's petition for rehearing, and restate and amend our original decision as indicated above.

O R D E R

Pursuant to the views expressed in the opinion of the Board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED, AND DECREED, pursuant to section 19047of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of California Steel Industries, Inc., against a proposed assessment of additional franchise tax in the amount of $901,729.40 for the year ended December 31, 1995, and the amount of $13,055.36 for the year ended December 31, 1996, be and the same is hereby reversed to the extent the amounts paid by California Steel Industries, Inc., to the independent contractors do not include amounts attributable to non-labor costs, unless California Steel Industries, Inc., has verified payment of sales or use tax on these items. The determination of respondent is sustained with respect to unsubstantiated costs and in all other respects.

Done at Sacramento, California, this 9th day of July 2003, by the State Board of Equalization, with Board Members Ms. Carole Migden, Mr. Claude Parrish, Mr. Bill Leonard, Mr. John Chiang, and Ms. Marcy Jo Mandel present.

Carole Migden, Chairwoman

Claude Parrish, Member

Bill Leonard, Member

John Chiang, Member

*Ms. Marcy Jo Mandel, Member

* For Steve Westly per Government Code section 7.9