

Cal-Tax Digest

This article is from Cal-Tax Digest, published
by the California Taxpayers' Association.
Cal-Tax Home Page | About Cal-Tax | Subscribe

July 2001

State Taxes



Audits of California's MIC: An Examination of Major Issues in Controversy

By Chris Micheli and Michael D. Herbert

This article provides an overview of emerging issues of controversy on audits of the Manufacturers Investment Credit (MIC) in California. These audits are being conducted by the California Franchise Tax Board (FTB) and are taking a more combative turn as the FTB believes significant MIC assessments will be made against taxpayers. Thus, the major issues emerging in these audits should be reviewed and monitored by taxpayers and taken into consideration in future planning activities.



Chris Micheli is an attorney and registered lobbyist for the Sacramento governmental relations firm of Carpenter Snodgrass & Associates (916-447-2251). He served as the lead lobbyist on the original MIC legislation and partial exemption statutes.

I. OVERVIEW OF THE MIC STATUTES

In 1993, California enacted a 6 percent investment tax credit and a partial (equal to 5 percent) sales/use tax exemption for the purchase of certain property (generally machinery and equipment) purchased for use by manufacturers (*See* California Revenue & Taxation Code [CRTC] §§ 17053.49 (personal income tax law) and 23649 (corporation tax law) [for the MIC] and 6377 [for the partial exemption]). The MIC statute has three major requirements:

Qualified Taxpayer Definition - For purposes of the MIC, the law provides that a "qualified taxpayer" is any taxpayer who falls within Standard Industrial Classification (SIC) Codes 2011 to 3999 (which is Division D, "Manufacturing"), or 7371 to 7373 (software developers) of the SIC Manual, 1987 edition. Generally, a qualified taxpayer may be an individual, partnership, C or S corporation, limited liability company, trust, or estate.

Qualified Property Definition - There are four major requirements for property to qualify for the MIC: It must be (1)

tangible personal property, (2) which is depreciable or amortizable under Internal Revenue Code Section 1245(a), (3) which is "primarily used" in the manufacturing or a related process, (4) which is placed in service in California on or after January 1, 1994.

Qualified Cost Definition - In addition, to qualify for the MIC, sales tax must be paid on the qualified property, and the costs must be properly chargeable to the taxpayer's capital account

Sunset Date - The MIC and partial exemption statutes will be repealed if 100,000 jobs in the manufacturing sector are not created by January 1, 2001, or on January 1 of the earliest year thereafter. However, the MIC can be carried forward after that event as provided by the statute.

According to the most recent data provided to the Legislature by the California Employment Development Department (EDD), there have been over 204,000 jobs in the manufacturing sector created since January 1, 1994. As a result, it is unlikely that the sunset date trigger will occur. Therefore, the MIC should remain in existence for the foreseeable future.

II. OVERVIEW OF CURRENT MIC AUDITS

According to taxpayers and FTB staff, field audits that focus on the MIC have begun in earnest. The FTB has established a special MIC website only available to FTB staff (*See Multistate Audit Technique Manual Section 9120, hereafter referred to as the "Manual"*). The guidance provided in the Manual for taxpayers consists of a very brief description of the basic requirements of the MIC. The absence of clear and public information has led some taxpayers to believe that the private website may amount to an underground regulation.

The lack of a dialog or process to resolve MIC issues with taxpayers has led to some audits being described by taxpayers as "aggressive." Moreover, FTB staff believes that there will be sizeable adjustments made, meaning that taxpayers will be denied credits and face larger tax bills, including interest and penalties.



*Michael D. Herbert
is a partner
at Andersen in
San Francisco and
advises clients on
claiming the MIC
(415-546-8247).*

*The authors would like
to thank E. Scott
Ewing of the Multistate
Credits and Incentives
Practice in the Los
Angeles Office of
Deloitte & Touche
LLP for his assistance
with this article.*

Recent FTB Legal Ruling

- On June 1, 2001, the FTB issued Legal Ruling 2000-1, which addresses the qualification of "capitalized labor" costs for the MIC.

- In Ruling 2000-1, the FTB determined that items of overhead and profit billed to the qualified taxpayer by a contractor are not allowable for the MIC because they are not "direct" costs of labor as defined in IRC Section 263A. In the example provided in the ruling, only amounts billed for sales or use taxable purchases on behalf of the taxpayer (minus the sales or use tax actually paid) and those for qualified capitalized labor are included in the MIC.
- Ruling 2000-1 does not provide any type of "safe harbor" or alternative method of calculating the MIC when the records of the contractor are unavailable. The best insurance is to get as much detail from a contractor as possible and, when appropriate, from subcontractors as well.

Taxpayers cannot be sure that auditors are using consistent, or even the latest, legal interpretations of the statute, regulations, and internal FTB guidance. This is also due to the fact that the FTB Legal Branch is still developing policies on key MIC issues. When a policy decision is made by FTB legal staff, it may take some time before auditors in the field learn of that position or interpretation.

Based upon recent experiences of taxpayers who have completed or are currently undergoing audits by the FTB, and based upon FTB attorneys' statements, major audit issues include the following:

III. QUALIFIED TAXPAYER ISSUES

Use of SIC Manual - The statute requires that a "qualified taxpayer" be one who is engaged in those lines of business described in Codes 2011 to 3999, inclusive, or Codes 7371 to 7373, inclusive, of the Standard Industrial Classification (SIC) Manual published by the United States Office of Management and Budget, 1987 edition. The MIC regulations determine whether a taxpayer is engaged in an activity that is described in Division D of the SIC Manual shall be made under the rules and methods described in the SIC Manual, 1987 edition. The statute has no such mandate.

According to the FTB, some taxpayers are simply focusing on whether their business activities can be said to be generally described in a Division D, Manufacturing, SIC Code without

When a policy decision is made by FTB legal staff, it may take some time before auditors in the field learn of that position or interpretation.

performing the classification analysis required by the SIC Manual. There is significant dispute between taxpayers and the FTB concerning the use of the SIC Manual in determining whether a business qualifies for the MIC.

Furthermore, various taxpayers are experiencing conflicting results when the SIC Code Manual is applied as interpreted by the FTB. For example, supermarket A, which has a separate facility for baking operations, can properly claim the MIC. However, supermarket B, which has its baking operations on the premises of its grocery store, cannot properly claim the MIC, according to the FTB.

This raises the question of why the same piece of equipment can qualify for the MIC for one taxpayer and not for another. Therefore, taxpayers are disputing whether the FTB is correct in its interpretation regarding the use of the SIC Code Manual principles of SIC Code classification.

Contracting Out - FTB audit staff is rumored to be asserting that, if a taxpayer does not engage in manufacturing at a single physical location (e.g., the taxpayer "contracts out" such as in a "fab-less" wafer manufacturer), then the business is not a qualified taxpayer. However, the FTB legal staff has stated that, if the taxpayer retains legal title or is the tax owner of the property produced, then the FTB will classify that taxpayer as being engaged in manufacturing.

MIC Audit Tips

Tips for taxpayers and professionals regarding their MIC audits:

- For the "qualified costs" definition to be met, sales or use tax must be paid, directly or indirectly, on each item of qualified property, and the costs must be properly chargeable to the taxpayer's capital account.
- To be "qualified property," the asset must be tangible personal property that is primarily used in the manufacturing or a related process.
- Real property and buildings (except special purpose buildings), as well as intangible property (e.g., patents and copyrights) do not qualify for the MIC.

- The FTB places the burden on the taxpayer to determine from contractors what the overhead and profit margin is on contract labor costs.
- Capitalized direct costs of labor will qualify for the MIC, but not indirect labor costs.
- It is critical for taxpayers to keep adequate records in order for them to substantiate their MIC claims upon audit.

IV. QUALIFIED COSTS ISSUES

Sales Tax Payment Requirement - A requirement for qualified costs is the payment of sales tax. Except for capitalized labor, in order to constitute qualified costs, sales or use tax must be paid, directly or indirectly, on each item of qualified property. The sales or use tax payment must be shown as a separately stated contract amount or determined from the books and records of the taxpayer.

Some taxpayers are erroneously including sales or use tax amounts paid to other states in their MIC calculation. Some taxpayers also erroneously include as qualified costs those amounts upon which no sales or use tax was paid or incurred.

Sales Tax Audits - The FTB seems to be auditing the same records already audited by the State Board of Equalization (BOE) on their sales tax audits. While the FTB is accepting use tax audit results, they may not accept sales tax audit results.

Taxpayers are of the opinion that, if there has been a sales tax audit and no adjustments were made, then the FTB should not be able to come and audit the same records for the same year. The

FTB is currently revisiting the impact of the BOE audits. The formal audit position from the FTB is that BOE audits are valid for use tax purposes only, but not for sales tax purposes.

If independent verification of sales or use tax payment is required (such as, for example, because the BOE audit was for different years, the taxpayer is not a "retailer" under California sales tax law, etc.), the FTB will conduct sampling where appropriate to verify whether payment of the sales or use tax has been made.

Chargeable to the Capital Account - The statute requires the "qualified costs" to be properly chargeable to the taxpayer's

Some taxpayers are erroneously including sales or use tax amounts paid to other states in their MIC calculation. Some taxpayers also erroneously include as qualified costs those amounts upon which no sales or use tax was paid or incurred.

capital account. In addition, the MIC regulations state, "Amounts shall be treated as properly chargeable to capital account if under the qualified taxpayer's method of *tax accounting*, they are properly includable in the qualified taxpayer's basis for computing depreciation on the qualified property ." [emphasis added] The statute is silent as to whether the cost must be chargeable to the book or tax capital account. The MIC regulations may be too restrictive in using the tax capital account.

Amounts are treated as properly chargeable to the capital account if under the qualified taxpayer's method of tax accounting they are properly includible in the qualified taxpayer's basis for computing depreciation under CRTC Section 24353. Thus, for example, when items are "expensed" under IRC § 179, this requirement will ordinarily not be satisfied.

IRC Sections 1031/1033 Transactions - In computing the MIC when an item of property has been exchanged for qualified property of a like-kind or if replacement property has been purchased following an involuntary conversion and gain realized, the amount that is properly chargeable to the capital account of the qualified taxpayer for California depreciation purposes is a carryover basis, which may be zero. The FTB's position is that, because no amount would be charged to the tax capital account, as opposed to book, no MIC is allowed for those dollars.

V. QUALIFIED PROPERTY ISSUES

Some of the most common issues arising from field audits are whether particular property is tangible personal property, or whether the property is being used as part of the manufacturing or a related process. Other audits have focused on whether a particular activity engaged in by the taxpayer falls within the proper SIC Code designation.

R&D Equipment - Another area of dispute between the FTB and taxpayers concerns the use of tangible personal property in research and development. Some taxpayers believe that the FTB audit staff is using a very narrow definition of R&D. The FTB's MIC regulations reference IRC Section 174 for the definition of R&D expenses. During the regulatory process, FTB staff argued for an IRC Section 41 definition, which is narrower than Section 174. However, FTB supervisors are not aware of audit staff deviating from this definition.

Another common error is the inclusion of equipment that is not used primarily in the taxpayer's manufacturing or other qualified activity.

Excluded Property - Taxpayers should remember that tangible personal property does not include real property, such as land or building (except special purpose buildings and foundations).

Also, the MIC does not include intangible property, such as patents and copyrights.

Pollution Control Equipment - One common error found in claiming the MIC involves qualified taxpayers who construct or acquire property used for pollution control. While some pollution control property qualifies (those that meet state, local or regional standards), some taxpayers erroneously include real property (such as land, storage buildings, etc.), land improvements (such as excavation costs), or inherently permanent structures in their MIC calculations. This property is not tangible personal property and, therefore, does not qualify for the MIC.

Another common error is the inclusion of equipment that is not used primarily in the taxpayer's manufacturing or other qualified activity. For example, computer software used to track or measure inventory would not qualify, according to the FTB, because this is general administration service, not a qualified activity. Taxpayers believe that the "primarily used" (50 percent or more of the time) test should be applied with these types of property.

Property Exclusions - Equipment categories that taxpayers mistakenly consider to be qualified property for purposes of the MIC include, according to the FTB: communications; security; fire prevention or warning systems, and transportation equipment.

While this type of equipment may be used in a qualified taxpayer's manufacturing facility, according to the FTB, these types of equipment generally are not used in manufacturing or other qualified activities and, therefore, are ineligible for the MIC. However, the authors believe that the MIC may be allowed for some of these types of items on appeal to the BOE.

In addition, according to the FTB, examples of property used in a non-qualified activity include storage racks or freezers used to store finished goods and forklifts used in warehousing activities, such as transporting finished goods to storage or the taxpayer's warehouse. Loading docks would also not qualify because they are generally used outside of the manufacturing process.

Moreover, items such as bins, tanks or racks used to collect or hold raw materials that are located off-site from the taxpayer's manufacturing facility would not qualify for the MIC. The raw materials have not been introduced into the manufacturing process and the property is not being used in a qualified activity.

Section 1245(a) Property Limitations - It is often difficult to identify IRC Section 1245(a) property in the manufacturing setting. Sometimes assets in a manufacturing environment seem to be IRC Section 1245(a) property, but perhaps are really leasehold improvements that are more properly classified under IRC Section 1250. Another issue is raised in this context: To what extent, if at all, will the FTB accept cost segregation studies and is it too burdensome to require taxpayers to go through such studies?

In addition, some taxpayers have argued that the MIC regulations are too narrow because the MIC statute references IRC Section 1245(a), which subsection includes both 1245(a)(3)(A) and (B). The FTB believes that the statutory phrase "tangible personal property that is defined in Section 1245(a)" contained in CRTC Section 23649(d) specifically references (and was intended to narrowly reference) IRC Section 1245(a)(3)(A).

FTB Legal Data

Since the MIC's enactment in 1994, the FTB staff has issued four chief counsel rulings on the MIC (seven requests have been made). These are not made public and cannot be used by any taxpayer other than the one who made the request. In addition, five Information Letters have been issued to taxpayers, but no Opinion Letters have been issued. The FTB no longer issues audit rulings and none has been issued on the MIC.

The MIC statute's reference to "personal property" and the plain language of IRC Section 1245(a)(3)(A) are limited to "personal property." Because the MIC statute references IRC Section 1245(a) and tangible personal property, the FTB is proposing to utilize the *Whiteco v. Commissioner* case [65 T.C. 664 (1975)] factors in examining whether any particular asset is an inherently permanent structure rather than tangible personal property. Taxpayers should be familiar with this decision and related cases in analyzing whether specific items of property constitute tangible personal property for purposes of the MIC.

A ripe area for controversy and likely litigation in the future concerns "capitalized labor," especially those costs associated with third-party construction contracts.

The factors in the *Whiteco* case include:

- Can the property be moved or has it been moved?
- Is the property designed to remain permanently in place?
- Are there circumstances that show the property may or will have to be moved?
 - Is the property readily moveable?
- How much damage would the property sustain when it is moved?
 - How is the property affixed to land?

Second Use of SIC Code - In addition to being a qualified taxpayer, the FTB believes that the business must also use the qualified property in an activity described in Division D of the SIC Manual. Accordingly, even though a taxpayer is properly classified as engaged in those lines of business described in an appropriate SIC Code, taxpayers must also analyze the activity to determine whether the property is actually being used in that qualified SIC Code activity. Arguably, however, the statute is merely repeating the qualified taxpayer definition.

Dual Use Property - According to the FTB, they have encountered some instances in which certain assets are utilized for more than one purpose (manufacturing element and some non-manufacturing element in the same asset, such as concrete trucks). Generally, the elements of the asset are now being bifurcated by the FTB so that the portion of the asset primarily used in manufacturing may be eligible for the MIC.

Capitalized Labor Issues - For purposes of the MIC, the "direct vs. indirect cost" principles of IRC § 263A have been borrowed to determine capitalized direct costs of labor (distinguished from indirect labor costs) that will qualify for the capitalized-direct-costs-of-labor exception to the general rule that sales or use tax must be paid on property in order for the costs to constitute qualified costs under the MIC. A ripe area for controversy and likely litigation in the future concerns "capitalized labor," especially those costs associated with third-party construction contracts.

Documentation Burden for Self-Construction and Contractors -

The FTB is taking the position that the MIC should not be calculated on items such as overhead or the mark-up taken by contractors in construction contracts. The FTB is putting the burden on the taxpayer to determine from the contractors what the overhead and profit margin is, or requiring a burdensome

formula to estimate those costs. FTB Legal Rulings 98-1 and 2000-1 provide additional guidance in this area.

Third Party Contractors - FTB Legal Ruling 2000-1 was issued to clarify the computation of direct labor costs with respect to third-party contractors. According to Ruling 2000-1, a "look-through" analysis must be performed for the third party so that only the third-party's direct labor costs will constitute qualified costs. While direct capitalized labor costs (including basic compensation, overtime pay, payroll taxes, holiday pay, and sick pay) also qualify for the MIC, some taxpayers are erroneously including "indirect labor" costs, such as training, insurance, travel and business expenses, and other charges.

This conclusion is consistent with the position the FTB has maintained since the MIC statutes were originally enacted. Nonetheless, the question remains whether IRC Section 263A is needed at all. Taxpayers may argue that all of a contractor's costs are direct costs for a project and only the taxpayer can incur indirect costs.

VI. LEASING ISSUES

The biggest audit issues in leasing are that there are specific rules that must be followed in order to ensure that purchases qualify for the MIC.

General Issues - Sales or use tax payments in a leasing transaction may either be made upon the acquisition of the item of property to be leased (sales or use tax payment based on the acquisition price of the asset) or periodically during the term of the lease (use tax payment based on the amount of the lease payment). For purposes of the MIC, generally the lessor must elect to pay the sales tax upon the acquisition of the leased property based upon the acquisition price of the asset to the lessor.

Non-Finance Leases - For non-finance leases to qualify for the MIC, parties to a leasing transaction must deviate from the normal business practice of collecting and remitting use tax on the lease payment stream, essentially treating the transaction as a finance, or capital, lease. Another important rule for purposes of the MIC is that the sales and use tax treatment of a lease is used to analyze the transaction, rather than the income tax treatment of that lease.

Operating Leases - Under a lease that would normally be construed as an operating lease for sales tax purposes (true lease

It is clear that the MIC, due to the value of credits claimed by taxpayers that are at stake, will be a significant area of controversy between the FTB and taxpayers.

where property returns to lessor at end of the lease term and the transaction is treated as a continuing sale under California sales tax law), the California sales or use tax paid by the lessor must be based on the lessor's acquisition price for the lessee (not the lessor) to claim the MIC.

Finance Leases - Under a lease construed as a finance lease for sales tax purposes (de facto sale where title transfers to lessee at end of lease term and treated as an immediate sale under California sales tax law), either the lessor or the lessee must pay California sales or use tax upon inception of the leasing transaction.

VII. OTHER ISSUES

Lack of Substantiation - Some taxpayers have claimed the MIC, but have not kept adequate records to substantiate the credit upon audit. The MIC regulations promulgated by the FTB have specific record-keeping requirements. In addition, the final footnote in FTB Legal Ruling 2000-1 provides insights into the substantiation rule.

Aggressive MIC Claims - Some taxpayers have not done a thorough review of their property to ensure that all property included in their MIC calculation is qualified. Some businesses are simply multiplying the MIC percentage by all capitalized property.

VIII. CONCLUSIONS

It is clear that the MIC, due to the value of credits claimed by taxpayers that are at stake, will be a significant area of controversy between the FTB and taxpayers. A number of issues relating to the proper interpretation of the provisions of the MIC statute, as well as the implementing regulations adopted by the FTB, will likely only be resolved through an appeal to the five-member State BOE, or ultimately through taxpayer litigation. Businesses that have claimed or plan to claim the MIC should closely follow these audit issues.

©Chris Micheli and Michael D. Herbert, 2001. This article appeared in, and is reproduced with the permission of, the Journal of Multistate Taxation and Incentives, July 2001, published by Warren, Gorham & Lamont, a division of RIA.