STATE OF RHODE ISLAND AND PROVIDENCE PLANTATIONS

DIVISION OF TAXATION

ADMINISTRATIVE HEARING

FINAL DECISION AND ORDER

#2011-21

STATE OF RHODE ISLAND AND PROVIDENCE PLANTATIONS
DEPARTMENT OF REVENUE
DIVISION OF TAXATION
ONE CAPITOL HILL
PROVIDENCE, RHODE ISLAND 02908

In the Matter of:	:	
	:	Case No. 11-T-007
	:	Historic Tax Credit
Taxpayer.	:	

DECISION

I. INTRODUCTION

A Notice of Hearing and Appointment of Hearing Officer ("Notice") was issued on February 4, 2011 by the Division of Taxation ("Division") to "Taxpayer") in response to its request for a hearing. A hearing was held on July 14 and August 4, 2011. Both parties were represented by counsel and briefs were timely filed by October 26, 2011.

II. JURISDICTION

The Division has jurisdiction over this matter pursuant to R.I. Gen. Laws § 44-1-1 *et seq.*, R.I. Gen. Laws § 44-33.2-1 *et seq.*, the *Division of Taxation Administrative Hearing Procedures Regulation AHP 97-01*, and the *Division of Legal Services Regulation 1 Rules of Procedure for Administrative Hearings*.

III. ISSUE

The parties agreed that this is a matter of mixed law and fact. First, are costs incurred by a related business entity and marked up to fair market value in an intercompany transaction allowable as a qualified rehabilitation expense ("QRE") to the

payor/claimant under the Historic Tax Credit Act? Second, if allowable as QREs, are there limitations on how much such actual costs can be marked up?

IV. MATERIAL FACTS AND TESTIMONY

The parties agreed to a joint statement of facts which provided in part as follows:[1]

1. The Division is a state agency statutorily charged, *inter alia*, with the administration and enforcement of all state taxes and state tax credit programs.

2. The Division jointly administers the Historic Tax Credit with the Rhode Island Historical Preservation and Heritage Commission ("Historical Commission"). R.I. Gen. Laws § 44-33.2-4. The Historical Commission determines whether a building qualifies as a historic structure (R.I. Gen. Laws § 44-33.2-4(a)(i)) and certifies whether the proposed development plan is historically accurate. *Id.*, at (a)(ii)(A). The Division reviews and audits financial data submitted by a tax credit applicant (R.I. Gen. Laws § 44-33.2-5) and certifies the amount of tax credit allowed. R.I. Gen. Laws § 44-33.2-4(a)(ii)(B).

3. "Taxpayer") was a foreign limited liability company organized under the laws of Nevada in May of 2004 who registered to do business in this state in September of 2006.[2] During the time frame at issue, had its principal place of business located at Pawtucket, Rhode Island but listed a mailing address for a contact person in Hollywood, California. The declared purpose of this business entity was real estate holding company and the manager of the company was identified as Exhibit One (1).[3]

4. was a limited liability company organized under the laws of Rhode Island in July of 2006.[4] During the time frame at issue, had its principal place of business located at in Pawtucket, Rhode Island but listed a mailing address for a contact person in Hollywood, California. The declared purpose of this business entity was real estate

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[1] The parties agreed that this matter is before this forum for formal administrative hearing pursuant to R.I. Gen. Laws § 44-1-32 on a Partial Disallowance of Qualified Rehabilitation Expenditures (QREs) and the concomitant reduction of tax credits claimed under the Historic Structures Tax Credit a/k/a Historic Preservation Investment Tax Credit (Historic Tax Credit) program for Phase 3 of the project. The parties further stated that the Historic Tax Credit, R.I. Gen. Laws § 44-33.2-1 *et seq.*, lacks specific provisions for administrative hearing on the denial of tax credits. However, R.I. Gen. Laws § 44-1-32 (the Tax Code) does contain a general hearing statute whereby "[a]ny taxpayer aggrieved by the action of the tax administrator in determining the amount of any tax or penalty for which hearing is not provided may apply...in writing within thirty (30) days after the notice...for a hearing." Given the remedial nature of this provision, it is broadly construed to also allow hearing when tax credits are denied or reduced. See *Dart Industries, Inc. v. Clark*, 657 A.2d 1062 (R.I. 1995) (general refund statute construed).

[2] Certificate of Organization/Registration was revoked as of May 25, 2010.

[3] The exhibits referenced in the agreed statement of facts refer to the parties' joint exhibits.

[4] Certificate of Organization/Registration was revoked as of May 25, 2010.

holding company and manager of the company was identified as Exhibit Two (2).

5. was a limited liability company organized under the laws of Rhode Island in January of 2007.[5] During the time frame at issue, had its principal place of business located at in Pawtucket, Rhode Island but listed a mailing address for a contact person in Hollywood, California. The declared purpose of this business entity was real estate holding company and the manager of the company was identified as its members. Exhibit Three (3).

6. was a domestic for profit corporation chartered under the laws of Rhode Island in May of 2005.[6] During the time frame at issue, , had its principal place of business located at in Pawtucket, Rhode Island. The declared purpose of this business entity was real estate development, maintenance, and management services and the sole officer of the corporation was identified as Exhibit Four (4).

7. was a limited liability company organized under the laws of Rhode Island in July of 2006.[7] During the time frame at issue, had its principal place of business located at in Pawtucket, Rhode Island but listed a mailing address for a contact person in Hollywood, California. The declared purpose of this business entity was real estate holding company and the manager of the company was identified as Exhibit Five (5).

8. was a foreign limited liability company organized under the law of Nevada in March of 2005 who registered to do business in this state in March of 2005.[8] During the time frame at issue, had its principal place of business located at in Pawtucket, Rhode Island. The declared purpose of this business entity was real estate holding company and the managers of the company were identified as . Exhibit Six (6).

9. The above six (6) business entities are all related companies having ties of common ownership and control. Exhibit Seven (7) (Chart of relationship and ownership).

10. is a for profit corporation organized under the laws of Rhode Island in May of 2006. During the time frame at issue, had its principal place of business located at in Baton Rouge, Louisiana. The declared purpose of this business entity was tax credit finance (sic). Exhibit Eight (8).

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[5] Certificate of Organization/Registration was revoked as of May 25, 2010.
[6] Certificate of Incorporation/Authority was revoked as of October 21, 2009.
[7] Certificate of Organization/Registration was revoked as of May 25, 2010.
[8] Certificate of Organization/Registration was revoked as of May 25, 2010.

11. In 2005, initiated a project to renovate some mill structures formerly known as the that were located at in Pawtucket, Rhode Island. In August of 2005, filed a Request for Certification of Historical Significance (Part I Certification) with the Historical Commission and the renovation project was assigned Project Number . Exhibit Nine (9). filed a Request for Certification of a Proposed Rehabilitation Plan (Part 2) with the Historical Commission in December of 2005. Exhibit 11.

12. On May 25, 2006, the Historical Commission certified the mill structures at as having Historic Significance (Exhibit Ten (10)) and approved the Proposed Rehabilitation Plan. Exhibit 12.[9] The rehabilitation was proposed and approved as a multiple phase project. Exhibits 11, 12, and 13.

13. and entered a contract for construction expenses and services relating to the project on September 20, 2006. Exhibit 14.

14. Phase I of the project was completed and received a Certification of Completion (Part 3 Certification) from the Historical Commission on September 10, 2007. Exhibit 15.

15. On October 10, 2007, and entered two leases for workspace at the complex at in Pawtucket. Exhibit 16.

16. and entered a contract for development services on December 31, 2007. Exhibit 17.

17. On May 14, 2008, filed an application and remittance form with the Division to reserve Historic Tax Credits for the renovation of the structures; now denoted as indicated that the renovation was a sixty (60) month phased project that commenced in January of 2006 and would entail as many as five (5) annual phases. estimated that the QREs for all the remaining phases would be and requested that it be issued 25% tax credits. remitted a Processing Fee of along with this application. Exhibit 18.

18. On May 15, 2008, and the Division entered a Contract of Guaranty for the Historic Tax Credits based upon the estimated QREs of Exhibit 19.

[9] The Certification of Historical Significance was a preliminary determination. As a rehabilitation project unfolds, it is always subject to change and revisions with the need for supplementary applications for approval. The standards for rehabilitation are established by the US Department of Interior and this necessitates a corresponding federal review and approval of any Proposed Rehabilitation Plan. Exhibit 13.

19. Phase 2 of the project was completed and received a Certification of Completion (Part 3 Certification) from the Historical Commission on June 3, 2008. Exhibit 20.

20. On September 9, 2008, entered an Agreement of Assignment and Assumption with whereby , as Assignor, granted, transferred, conveyed and assigned all its rights, title and interest in the Contract of Guaranty for Historic Tax Credits and all rights and obligations thereunder to as Assignee. Exhibit 21.

21. On December 1, 2008, entered an Agreement whereby it collaterally pledged the Contract of Guaranty for Historic Tax Credits to Stonehenge Tax Credit Fund as security for a loan of The Division acknowledged and consented to this collateral assignment and pledge. Exhibit 22.

22. On September 29, 2009, acting through its CPA, submitted documentation in support of a Certificate of Completed Work (Part 3 Certification) for Phase 3 of the project. Exhibit 23. On the last page of this document was a Schedule summarizing both Total Costs and Qualified Rehabilitation Expenses for Phase 3 of the project as of December 31, 2008. The Taxpayer indicated that it was claiming in QREs (which equates to in tax credits) for this phase of the project. Exhibit 23 at p. 4.

23. On November 23, 2009, the Historic Commission approved certification of Phase 3 of the project as meeting its standards for historic preservation. Exhibit 24.

24. On December 12, 2009, the Division auditors assigned to review the accounting records for Phase 3 of the project indicated, by internal memorandum, that they could only approve approximately 75% of the claimed QREs. Exhibit 25. They initially found three (3) issues of concern identified as "interest, wages, and windows." *Id.*

25. On December 24, 2009, the Taxpayer was advised, in writing, that of the claimed QREs for Phase 3 of the project were allowed and that certain items were disallowed. Exhibit 26. As a result of the partial disallowance of QREs, was issued certificates for Historic Structures Tax Credits totaling *Id.*

26. The Taxpayer made a timely request for administrative review of its tax credit determination in correspondence dated January 6, 2010 and January 20, 2010 respectively. Exhibit 27.

27. On January 28, 2010, the Division advised the Taxpayer as to the basis for partial disallowance of the claimed QREs for Phase 3 of the project Exhibit 28) and provided workpapers detailing the adjustments made. Exhibit 29.

28. Based on additional information provided at preliminary review, on March 25, 2010, the Taxpayer was allowed in additional QREs for Phase 3 of the project. This resulted in the issuance of in Historic Structures Tax Credits. Exhibit 30.

29. After this preliminary review, the only item in dispute was in QREs the Taxpayer claimed for the rehabilitation or restoration of the project's windows. Exhibit 23 at p. 4. In support of these claimed QREs the Taxpayer presented the Division with an invoice dated November 27, 2008 from to for due on receipt. Exhibit 31.

30. Annotations on the invoice indicated that the labor and overhead attributable to the windows were already claimed under other entries on the Summary of Total Costs and Qualified Rehabilitation Expenses for Phase 3 of the project. Exhibits 31 and 23.

31. A CPA's detailed break-out of the 2008 expenditures behind the various entries on the Summary of Total Costs and Qualified Rehabilitation Expenses for Phase 3 of the project provided no specifics as to what comprised the claimed as QREs for the windows. Exhibit 32.

32. The Taxpayer produced invoices for tools, equipment, material and supplies acquired from various local vendors that were used or consumed in the rehabilitation or restoration of the project's windows. Exhibit 33. These items totaled and were all allowed as QREs for windows in Phase 3 of the project. Exhibits 29 and 33.

33. The Taxpayer later produced additional invoices and information totaling of costs incurred by relating to window repair and restoration. Of this amount, the Division allowed an additional in QREs and approved another in QREs for allowance subject to confirmation. These sums are for expenditures in addition to the previously allowed. Exhibit 34.

34. Analysis of a payroll report of for 2008 indicates that of its labor costs were attributable to the Exhibit 35.

35. project entailed the restoration of six hundred ninety one (691) windows; two hundred thirteen (213) of which were rehabilitated or repaired and four hundred seventy eight (478) of which were reconstructed or manufactured. Exhibits 36 and 37 (drawings and before and after pictures). The project also entailed work on window jambs, doors and door frames.

36. In support of its claim of QREs for window restoration, the Taxpayer submitted several estimates or quotes from independent third parties of what they would have charged to perform the work off site at their facilities. Exhibit 38.

37. The partnership return filed by for calendar year 2008 reflects only gross receipts of is a cash basis taxpayer for tax purposes. Exhibit 40.

38. The Taxpayer agrees that of the labor costs claimed for window restoration was duplicated in that it was included in the overall labor allowed as QREs for Phase 3 of the project. Accordingly, the QREs for the windows should be reduced.

testified on behalf of the Taxpayer. He testified that he is vice-president of where his duties include estimating costs for potential company projects. See Taxpayer's Exhibit Two (2) (resume). He testified that his company bid on the Taxpayer's window project but was not hired and he reviewed the completed window work and its market value was which was the same as his company's bid. He testified that profit margins are built into an estimate with a sub-contractor having a 20% margin and a general contractor having a 7% to 10% margin so the profit margin on the total window package would be 25% to 30%. He testified that if a company sells a product to an interrelated company, profit margins are built in.

On cross-examination, testified that the project was for approximately 700 windows to be repaired or replaced. He testified that the value is based on taking the windows off-site for repair but the price is the same today as in 2008 because of the nation's economy. He testified that in his experience, profit margins would be built into related corporations and the companies would pay each other for services based on off-setting book entries.

testified on behalf of the Taxpayer. He testified that he is employed by where he is the Director of Development. He testified that he is familiar with the entire project which is an historic renovation in five (5) phases with the third phase being placed into service on December 31, 2008. He

testified that 213 windows were manufactured, 478 windows were rehabilitated, 78 door jams were rehabilitated, and five (5) historic door replicas were manufactured and all work was approved by the Historic Preservation Society. He testified that is a limited liability company wholly owned by , and performed the work for He testified that prior to performing the work on the windows, the job was put out to bid and bids from to were received. He testified that submitted a invoice for reimbursement to which was submitted to the owner, for reimbursement. He testified that did not object to the invoice but has not reimbursed so there is still a receivable for that amount. He testified that the invoice was submitted by a CPA firm as required by statute and there were no issues.

On cross-examination, testified that has performed no other projects except this project. He testified that set-up shop in the mill complex.[10] He testified that there was a 29% mark up with approximately labor and in materials as well as the cost of doing business and that adds up to as supported by documentation.

On redirect examination, testified that planned to perform window work for other companies but had not mostly because of the economy. He testified that costs for potential advertising, sales, and testing were set at under He testified that those costs were not incurred but were a valid component of a

[10] He testified that rent was paid but at hearing, it was represented that rent was not included in the QRE. However, rent apparently is included in documentation justifying expenses. See Taxpayer's Exhibits 1(A), 1(22), and 1(23).

fair market value bid. Tr1 at 58.[11] He testified that for financial reporting purposes was accrual based and would only pay taxes on cash actually received. He testified that there is a receivable on its book for that has not been paid. He testified that the common percentage of ownership between and is under 50%.

On further cross-examination testified that included overhead and potential advertising and sales costs as part of its cost of doing business and has not performed any other window projects. He testified that the employees of were paid through

Senior Revenue Agent with the Division, was called by the Taxpayer. He testified that he reviews related companies' transactions and if companies are not two (2) separate entities, he disallows the QRE. He testified that in order to determine the control of an entity, he reviews the combination of ownership and management as well as with whom the company does business and the amount of the transaction. He testified that he knew there was common ownership and management in this matter. He testified that he did review Exhibit 23, the CPA report, and he normally gives deference to an independent accountant's audit report after financial statements have been certified but just because something is on the CPA report does not mean it has to be accepted. He testified that he did not accept this QRE because it was not an arm's length agreement since the parties basically set their own fee. He testified that to have an arm's length agreement, there needs to be an independent agreement on a price which did

[11] Tr1 refers to the transcript of the first day of hearing on July 14, 2011 hearing. Herein, Tr1 and Tr2 shall refer to the first and second day of hearing with page numbers noted following Tr1 or Tr2.

not exist in this matter. He testified that he has never disallowed a transaction for not being at arm's length but rather it is common sense.

On cross-examination, testified he does not automatically disallow for affiliated entities but there is heightened scrutiny especially when the transaction is not backed up by third party invoices and he also looked more closely because of the qualifying note on the invoice in Exhibit 31 which stated that labor and overhead were not included so it made him wonder how separate the companies really were.

V. DISCUSSION

A. Legislative Intent

The Rhode Island Supreme Court has consistently held that it effectuates legislative intent by examining a statute in its entirety and giving words their plain and ordinary meaning. *In re Falstaff Brewing Corp.*, 637 A.2d 1047, 1049 (R.I. 1994). See *Parkway Towers Associates v. Godfrey*, 688 A.2d 1289 (R.I. 1997). If a statute is clear and unambiguous, "the Court must interpret the statute literally and must give the words of the statute their plain and ordinary meanings." *Oliveira v. Lombardi*, 794 A.2d 453, 457 (R.I. 2002) (citation omitted). The Supreme Court has also established that it will not interpret legislative enactments in a manner that renders them nugatory or that would produce an unreasonable result. See *Defenders of Animals v. Dept. of Environmental Management,* 553 A.2d 541 (R.I. 1989) (internal citation omitted). In cases where a statute may contain ambiguous language, the Supreme Court has consistently held that the legislative intent must be considered. *Providence Journal Co. v. Rodgers*, 711 A.2d 1131 (R.I. 1998). The statutory provisions must be examined in their entirety and the meaning most consistent with the policies and purposes of the legislature must be effectuated. *Id.*

B. Relevant Statutes and Regulation

R.I. Gen. Laws § 44-33.2-2 provides in part as follows:

> Definitions. – As used in this chapter:
> ***
> (8) "Qualified rehabilitation expenditures" means any amounts expended in the rehabilitation of a certified historic structure properly capitalized to the building and either: (i) depreciable under the Internal Revenue Code, 26 U.S.C. § 1 et seq., or (ii) made with respect to property (other than the principal residence of the owner) held for sale by the owner. Fees pursuant to § 44-33.2-4(d) are not qualified rehabilitation expenditures. Notwithstanding the foregoing, except in the case of a nonprofit corporation, there will be deducted from qualified rehabilitation expenditures for the purposes of calculating the tax credit any funds made available to the person (including any entity specified in § 44-33.2-3(a)) incurring the qualified rehabilitation expenditures in the form of a direct grant from a federal, state or local governmental entity or agency or instrumentality of government.

R.I. Gen. Laws § 44-33.2-5 provides as follows:

> Information requests. – The tax administrator and his or her agents, for the purpose of ascertaining the correctness of any credit claimed under the provisions of this chapter, may examine any books, paper, records, or memoranda bearing upon the matters required to be included in the return, report, or other statement, and may require the attendance of the person executing the return, report, or other statement, or of any officer or employee of any taxpayer, or the attendance of any other person, and may examine the person under oath respecting any matter which the tax administrator or his or her agent deems pertinent or material in determining the eligibility for credits claimed and may request information from the commission, and the commission shall provide the information in all cases, to the extent not otherwise prohibited by statute.

The Division's Regulation CR 08-13 ("CR 08-13")[12] provides in part as follows:

> Article V Application Guidelines
> ***
> 4. Certifications of Rehabilitation
> ***
> B. Scope of Rehabilitation; Qualified Rehabilitation Expenditures. For purposes of Commission reviews and certification, a Rehabilitation project encompasses all work on the interior and exterior of the certified historic building(s) and its site and environment, as well as related demolition, new construction or rehabilitation work that may affect the historic qualities,

[12] Promulgated pursuant to R.I. Gen. Laws § 44-33.2-1 *et seq.*

integrity, site, landscape features, and environment of the property. The Commission will determine if such work is consistent with the standards for Rehabilitation whether or not a Credit is claimed for those costs. However, only those costs that constitute Qualified Rehabilitation Expenditures may be included in the calculation of the Historic Preservation Investment Tax Credit. The Commission and the Tax Division are entitled to rely on the Accountant's Certification regarding the Qualified Rehabilitation Expenditures actually incurred included with the Application without independent investigation. However, the Tax Division reserves the right to request additional documentation and supporting detail to verify Qualified Rehabilitation Expenditures, including but not limited to, the original documents of entry, vendor lists, payroll record, accounts, and other records.

***

D. Determination of Qualified Rehabilitation Expenditures. The Tax Division, upon receipt of the complete application describing the Rehabilitation Project, shall determine if the costs attributed to the Rehabilitation meet the criteria of Qualified Rehabilitation Expenditures. If any costs of a project are denied as Qualified Rehabilitation Expenditures, the Tax Division shall advise the Applicant of that fact in writing briefly setting forth the grounds for said denial.

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Article VI Substantial Rehabilitation; Qualified Rehabilitation Expenditures

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2. Qualified Rehabilitation Expenditures.

A. Qualified Rehabilitation Expenditures are those expenses incurred in connection with a Substantial Rehabilitation of a Certified Historic Structure that are properly capitalized to the building and either (i) depreciable under the Internal Revenue Code or (ii) made with respect to property (other than the Principal Residence of the Owner) held for sale by the Owner.

B. Amounts are properly capitalized to the building if they are properly includible in computing the depreciable basis of real property under federal income tax law. Amounts treated as an expense and deducted in the year paid or incurred or amounts that are otherwise not added to the basis of real property do not qualify. ***

C. Expenses that do not qualify as Qualified Rehabilitation Expenditures include, without limitation:

(1.) The cost of acquiring a building, an interest in a building (including a leasehold interest) or land. ***

(2.) Any expense attributable to an enlargement of a building. ***

(3.) Any expense attributable to the rehabilitation of a Certified Historic Structure, or a building located in a Registered Historic District, which is not a Certified Rehabilitation.

(4.) Any site work expenses.

(5.) Any costs of demolition of adjacent structures.

(6.) Processing Fees imposed under Section 44-32.2-3(b) and Section 44-33.2-4(d).

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Article VII Determination of Credit

1. The amount of the Credit shall be determined by multiplying the total amount of Qualified Rehabilitation Expenditures incurred in connection with the plan of Rehabilitation times the appropriate percentage as elected in the Contact. Qualified Rehabilitation Expenditures may include expenses in connection with the Rehabilitation which were incurred prior to the start of Rehabilitation or of the Measuring Period. Further, Qualified Rehabilitation Expenditures may include expenses incurred prior to completion of a formal plan of Rehabilitation provided the expenses were incurred in connection with the Rehabilitation which was completed.

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4. The Tax Division may rely without independent investigation on the Accountant's Certification as to the amount of Qualified Rehabilitation Expenditures actually incurred and the satisfaction of Substantial Rehabilitation test. However, the Tax Division reserves the right to review such Certifications and to audit the original documents of entry, vendor lists, payroll records, accounts or other records supporting such Accountant's Certifications.

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Article XI Miscellaneous

1. Administration and Examination of Records - Tax Division. The Tax Division and its agents, for the purpose of ascertaining the correctness of any Credit claimed under the Act, may examine any books, paper, records or memoranda bearing upon the matters required to be included in the return, report or other statement, and may require the attendance of the Person executing the return, report or other statement, or of any officer or employee of any taxpayer, or the attendance of any other Person, and may examine the Person under oath respecting any matter which the Tax Division or its agents deems pertinent or material in determining eligibility for Credits claimed, and may request information from the Commission, and the Commission shall provide such information in all cases, to the extent not otherwise prohibited by statute.

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3. Commission's and Tax Division's Right to Deny or Revoke Credit. If information comes to the attention of the Commission at any time up to and including the last day of the Holding Period that is materially inconsistent with representations made in an application, the Commission may deny the requested certification or revoke a certification previously given. If information comes to the attention of the Tax Division at any time up to and including the last day of the Holding Period that is materially inconsistent with representations made in the Accountant's Certification or any supporting

materials, the Tax Division may revoke the Assignable Historic Tax Credit Certificate and cancel a Contract for tax credits and any Processing Fees paid thereunder shall be forfeited. ***

C. **Arguments**

The Division argued that the ordinary statutory language is that a QRE is determined on the basis of actual costs incurred rather than the fair market value of the work performed. The Division argued that the canons of statutory interpretation of tax law mandates that tax benefits be strictly construed and to construe otherwise would contravene the legislative intent. The Division also argued that the project costs for a QRE must have some economic substance or reality. Thus, the Division argued the marketing and rental costs should be disallowed as those costs were not actually expended but it does not deny that there were actual expenditures on materials.

The Taxpayer argued that the QRE at issue was a depreciable fixed asset and properly capitalized as required by law. R.I. Gen. Laws § 44-33.2-2(8). The Taxpayer argues there is no basis in law to question this transaction because of related parties and the treatment of related parties should be consistent with other Rhode Island related transaction cases in that when such business transactions are scrutinized, they are found to be reasonable if the transactions represent fair market values.

However, the Taxpayer argued that the QRE is not based on fair market value but on the actual cost to Taxpayer as the purchaser of products and services which is based on the invoice from Thus, the Taxpayer argues that the issue is whether an intercompany transaction can be entered into at all, marked at its proper retail value in order to produce a profit for , and thus, whether to allow the invoice submitted as a QRE. (see Taxpayer's reply brief).

Since there is only 46% common ownership[13] of and , those entities cannot be consolidated under federal tax law; therefore, the Taxpayer argues that the proper tax basis for the QRE is the invoice price of And in evaluating the invoice, the Taxpayer argues that the invoice was a reasonable cost including the price of materials, marketing, and an industry acceptable mark-up for profit. The Taxpayer argues that payment is not relevant but rather the amount of was incurred and will be paid once cash flow is available and the marketing costs were included as part of the budgeting process for establishing a pricing model. The Taxpayer argues that separate companies are allowed to each generate a profit and mark-up their products to their fair market/retail value so that the QRE is an incurred expense.

D. What Expenses Should be Allowed

R.I. Gen. Laws § 44-33.2-2 defines QRE's as "any amounts expended" in rehabilitating a certified historic structure. On the face of it, the definition refers to any money spent in rehabilitation. A QRE is not defined as a reasonable cost nor is it defined as the fair market value.

In *Roadway Express, Inc. v. Rhode Island Commission for Human Rights*, 416 A.2d 673 (R.I. 1980), the Court relied on a dictionary definition in applying the "ordinary meaning" of "must." *Id.*, at 674. As the Court has found, "[i]n a situation in which a statute does not define a word, courts often apply the common meaning given, as given by a recognized dictionary." *Defenders of Animals, Inc.*, at 543. While any amounts expended is clear, it should be noted that *Random House Webster's Unabridged*

[13] Testimony at hearing indicated the ownership was less than 50%. Tr1 at 63. The Taxpayer relied on its Exhibit One (1) for the 46% figure which was not disputed by the Division.

Dictionary, 2nd Edition (1987) contains the following definitions: 1) Amount is defined as "the sum total of two or more quantities or sums; aggregate," and 2) Expend is defined as "to use up" and "to pay out; disburse; spend." As expected, any amount expended refers to the aggregate sum of what was paid out or spent.

As cited above, R.I. Gen. Laws § 44-32.2-5 authorizes the Division to examine papers, records, and anyone under oath to determine the eligibility of the credits. CR 08-13 was promulgated to assist in the implementation of this tax credit statute. As cited above, Article V(4)(B) and Article VII of CR 08-13 both allow the Division to rely on an Accountant's Certification[14] regarding the expenditures "actually incurred" without independent investigation but reserves the right for the Division to request additional documentation and supporting detail to verify the QRE including but not limited to original documents of entry, vendor lists, payroll records, accounts, and other records. Thus, the Division is to determine whether an expense claimed as a QRE was actually incurred. At the same time, Article VI(2) of CR 08-13 provides that there are certain expenses that do not qualify as a QRE and lists those expenses without limitation. Article XI(3) allows the Division to deny or revoke credit if information comes to the attention of the Division that is materially inconsistent with an applicant's application for credit.

The statute and its promulgating regulations provide that credit is to be given for the actual expense by a taxpayer for its historical rehabilitation. Thus, the issue is what expenses were incurred.

The Taxpayer chose to use a related company to perform the window work since it was cheaper than any bid received. The Taxpayer argued that in any business

[14] Said certification is defined in Article III of said regulation. It is a required certification containing specific information made by a Rhode Island licensed CPA and included in an applicant's application for an historic tax credit.

transaction, amounts paid are the actual cost to one company and a marked up cost to the other company so that the latter company can make a profit. Thus, the Taxpayer argues that its expense is the invoice and said invoice should be accepted because it represents the fair market value.[15] The Taxpayer argues that there is nothing in the statute that disallows such related company transactions and that the Division's auditor, disallowed the transaction in part on instinct and in part because the parties were related.

The fact that the parties were related did cause concern. He also testified that the notes on the Accountant's Certification (Exhibit 31) caused him concern. Because of his concerns, he reviewed the transaction further. However, the fact that the parties were related does not bar the Taxpayer from requesting and receiving a QRE. The same standard that applies to unrelated party transactions applies to related party transactions. The pertinent statute speaks of any amounts expended. Pursuant to R.I. Gen. Laws § 44-33.2-3-5 and CR 08-13, the Division can request documentation to support an application for a QRE and if it is found that an amount has not been expended than the QRE is disallowed. For example, if an applicant submitted an Accountant's Certification certifying but the Division discovered that the bill had been inflated for the purposes of obtaining a higher credit and the applicant had only really spent the credit would be disallowed as materially inconsistent with the application. The credit is not based on the value of work performed but on the amount spent on the work performed.

Therefore, the issue of whether the amount billed is reasonable or a fair market value is irrelevant. The Taxpayer argues that the submitted invoice and the amount billed is the QRE. However, that would defeat the purpose of the statute - as demonstrated by

[15] See, for example, Tr1 at 73; Tr2 at 35.

its clear and unambiguous language - that credit is to be given for the amount spent on rehabilitation. Hence, R.I. Gen. Laws § 44-33.2-5 authorizes the Division to determine the eligibility of claimed credits. Thus, CR 08-13 speaks of expenses "actually incurred" and taxpayers are limited in what kind of expenses qualify and the Division can review applications for credits and disallow them. Credits are to be for money spent on rehabilitation and not for example, on acquiring buildings or land, enlarging buildings, or demolishing adjacent structures. See CR 08-13.

The parties agreed that the amount of for labor costs was erroneously included in the requested QRE and should be deducted.[16]

In the Taxpayer's supporting documentation for its QRE,[17] rent in the amount of is included. Rent in the amount of is also listed on Exhibit 34 (Division analysis of claimed expenses). At hearing, the Taxpayer represented that rent was not included in the claimed QRE. Tr1 38-39.[18] Thus, the amount of should be deducted from the QRE.

The Division argued that the marketing expense of never existed so should not be credited. The Taxpayer argued that marketing was included in its pricing model so is part of the expenditure because it is part of the billed price. The Taxpayer also argued that the actual expense is not relevant and payment time varies based on cash flow. (Revised reply brief). The Taxpayer admitted that this window rehabilitation

[16] See agreed fact # 38, briefs, and transcripts.
[17] See Taxpayer's Exhibit One (1).
[18] The representation at hearing was that rent was not included in the claimed expense. Rent was carried on the books for space which testimony showed was located at the site of the project itself. There is no evidence that any rent was part of the rehabilitation work expenses. The undersigned accepts the representation from hearing that rent should not be included in the claimed QRE.

work was the only work ever performed by but argued that was because of the economy and marketing was a legitimate expense.

While it is true that marketing can be included in pricing models by sellers, it would be expected that such pricing would be built into labor costs or in the mark-up and not necessarily assigned to one customer. Nonetheless, did not incur any expenses related to marketing.[19] This statute is not concerned with pricing models. The marketing cost was not an amount expended either by or the Taxpayer. Since the marketing price was not an actual expense of the rehabilitation, it does not matter whether marketing is usually included in pricing. The statute speaks of money spent on rehabilitation.

Essentially, the Taxpayer argued that the Division would not have questioned a bill from a third party vendor even if marketing or advertising expenses were included in the price and were technically not part of the rehabilitation work. However, such a bill would not necessarily include marketing as a separate expense but most likely would have factored it into labor rates, etc. with costs spread out to customers. Nonetheless, how another vendor bills is not relevant to the issue of what money was expended on this rehabilitation. While Taxpayer argues that this invoice is an account receivable and will be paid, the Division has the right to review the documents to determine what amounts were actually *expended* on rehabilitation. A separate bill by a new company for marketing that was never performed is not an expenditure spent by either party on the window rehabilitation. Thus, it does not fall under the statute or regulation so that should be deducted from the QRE.

[19] Tr1 at 58.

Indeed, to find that the statute allows credit for any invoice submitted would render the statute meaningless as the statute clearly and unambiguously limits the giving of said credit to money spent on rehabilitation and not for any money paid to a vendor who performs rehabilitation work. The statute does not give credit for what is billed but instead what money is actually spent on the work. The Division has the right to determine whether money has been spent on rehabilitation work or not. To find otherwise would result in credit being given for items irrelevant to rehabilitation but were billed to a taxpayer by a vendor performing rehabilitation.[20] [21]

E. The Amount Allowed

The parties also argued about whether a mark-up was allowed on intercompany transactions. According to the Taxpayer, the sum of included a mark up of 29%. The Taxpayer presented testimony that a general contractor's mark-up would be 7% to 10% and a sub-contractor's mark-up would be 20%.

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[20] The Taxpayer argued that the requested QRE complies with statute and represents the expenses incurred. But the Taxpayer also implies that there is no basis to and it is not fair to challenge an intercompany transaction. Thus, it should be noted that equitable principles are not applicable to an administrative procedure. See *Nickerson v. Reitsma*, 853 A.2d 1202 (RI 2004). However, as discussed in this decision, the Division has the statutory and regulatory authority to question and deny claimed expenses whether from a third party vendor or a related company.

[21] As the Division points out in its brief, the purpose of tax credits is to compensate a taxpayer for the costs of providing something of benefit to society but it is not to be a gratuitous gift from public coffers at the expense of other taxpayers. This statute is clear on its face that credits are based on the actual expense of rehabilitation. Thus, there is no need to discuss the public policy behind this statute. However, it should be noted that tax benefits are narrowly construed against a taxpayer and in favor of the public for that very reason – tax benefits are not to be a gratuitous gift. *American Hoechst Corp. v. Norberg*, 462 A.2d 269 (R.I. 1983). See also *Fleet Credit Corp. v. Frazier*, 726 A.2d 452 (R.I. 1999). Thus, it is not surprise that this statute clearly provides for credits to be determined on "amounts expended" rather than on amounts billed or the fair market value.

Additionally, the 2008 amendments to the Historic Tax Credit Act provided that an applicant for credit pay a processing fee based on a percentage of the QRE. R.I. Gen. Laws § 44-33.2-3. But as the Division pointed out in its brief, the statutory scheme provides that "[i]n the event that the processing fee paid is greater than the amount of actual qualified rehabilitation expenditures multiplied by the percentage chosen . . . the persons . . . that incur qualified rehabilitation expenditures for the substantial rehabilitation . . . shall be refunded such difference, without interest." R.I. Gen. Laws § 44-33.2-3(b)(1)(E). In other words, the statute envisions that a QRE estimate on which the processing fee would be based might not equal the "actual qualified rehabilitation expenditures." Such statutory provision is consistent with the clear and unambiguous language of the statute that credits are for actual expenses and not for the amount billed and the Division is to make such determinations if necessary.

The Taxpayer hired its wholly owned subsidiary, [22] to perform the work. See Exhibit 31 (invoice). The Taxpayer submitted the invoice to as owner of the project. Tr1 at 34.[23] The Taxpayer argued that its mark-up of 29% was reasonable as it combined a general contractor and sub-contractor mark-up (see testimony regarding mark-ups). However, sub-contractors are companies that a general contractor hires to perform some of the work for which the general contractor contracted to perform. There was no evidence that sub-contracted out any of the work that would justify two (2) separate mark-ups: one for the general contractor and one for the sub-contractor. In this situation, the Taxpayer did not bid out part of the job to sub-contractors but rather its wholly owned subsidiary performed the work. Thus, the only relationship here was that of a general contractor. The evidence was that workers performed the work (with its workers being paid by as a common paymaster). Tr2 at 27.

The amounts of representing labor costs, representing rents, and representing marketing are all to be deducted from the QRE. Those three (3) items total The total amount of the three (3) disqualified items cannot be subtracted from since that amount includes the mark-up of amounts (labor, rent, and marketing) that are no longer included in the QRE. If a mark-up is accepted, it must be based solely on the amount expended in rehabilitation and not on disqualified amounts.

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[22] Tr1 at 37.

[23] The Taxpayer assigned its rights to these tax credits to See agreed fact # 20 and Exhibit 21. However, that has no bearing on the issue of sub-contracting.

Thus, the disqualified amounts must be deducted from the raw total expenditures. If rent and labor are deducted from the Taxpayer's claimed expenditure of [24] prior to mark-up, the sum is . In addition, the marketing amount cannot be added to that total as was done in Taxpayer's Exhibit One (1).

With a 29% mark up on the QRE would total x .29 = which is then added to . The 25% credit would total Without a mark up on the 25% credit would total . Thus, the credit due Taxpayer is between and

In its brief, the Division acknowledges that in restorations involving related companies, the amount of QRE claimed can reflect a reasonable mark-up in addition to labor and material costs to reflect overhead and administrative expense. Thus, the Division would not object to the reasonable mark-up of the actual expenditures in this matter. Based on the testimony at hearing regarding acceptable mark-ups for a general contractor, a reasonable mark-up would be 10%.

Thus, a 10% mark-up of the actual expenditure of results in the expenditure of x .10 = added to initial amount). The resulting credit is x .25).[25]

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[24] This amount is taken from Taxpayer's Exhibit One (1). Along with materials, this amount includes the amounts for rent and labor. The marketing amount was added to that amount and the mark-up was applied to the overall total which resulted in the amount of At hearing and during this decision, the requested QRE has been referred to as however, the specific amount was . See Taxpayer's Exhibit One (1) and Taxpayer's briefs. That specific amount does not affect the analysis in this decision.

[25] Taxpayer's Exhibit One (1) in particular Exhibit 1A includes costs from 2007 that are claimed for 2008. The testimony at hearing was that these expenses had not been claimed earlier. Tr1 at 42-43. However, the parties agreed that the payroll expense listed for 2008 had already been claimed. Therefore, if need be, this amount is subject to a review of Taxpayer's Exhibit One (1) to verify that the expenses (e.g. materials, payroll) listed for 2007 have not already been claimed. If any expenses have already been claimed, those expenses should be deducted from the **actual** expenditure and the mark-up and credit re-calculated.

VI. FINDINGS OF FACT

1. A Notice was issued on February 4, 2011 by the Division to the Taxpayer in response to its request for a hearing.

2. A hearing was held on July 14 and August 4, 2011. Both parties were represented by counsel and briefs were timely filed by October 26, 2011.

3. The facts contained in Sections IV and V are reincorporated by reference herein.

VII. CONCLUSIONS OF LAW

Based on the testimony and facts presented:

1. The Division has jurisdiction over this matter pursuant to R.I. Gen. Laws § 44-1-1 *et seq.* and R.I. Gen. Laws § 44-33.2-1 *et seq.*

2. Pursuant to R.I. Gen. Laws § 44-1-1 *et seq.* and R.I. Gen. Laws § 44-33.2-1 *et seq.*, the Taxpayer's claimed QRE shall be reduced as discussed above.

VIII. RECOMMENDATION

Based on the above analysis, the Hearing Officer recommends as follows:

Based on R.I. Gen. Laws § 44-44-1 *et seq.*, and R.I. Gen. Laws § 44-33.2-1 *et seq.*, the Taxpayer's claimed credit is reduced as discussed above.

Date: November 18, 2011

Catherine R. Warren
Hearing Officer

ORDER

I have read the Hearing Officer's Decision and Recommendation in this matter, and I hereby take the following action with regard to the Decision and Recommendation:

_____ ADOPT
_____ REJECT
_____ MODIFY

Dated: December 1, 2011

David Sullivan
Tax Administrator

NOTICE OF APPELLATE RIGHTS

THIS DECISION CONSTITUTES A FINAL ORDER OF THE DIVISION. THIS ORDER MAY BE APPEALED TO THE SIXTH DIVISION DISTRICT COURT PURSUANT TO THE FOLLOWING WHICH STATES AS FOLLOWS:

> R.I. Gen. Laws § 8-8-25 Time for commencement of proceeding against the division of taxation. – (a) Any taxpayer aggrieved by a final decision of the tax administrator concerning an assessment, deficiency, or otherwise may file a complaint for redetermination of the assessment, deficiency, or otherwise in the court as provided by statute under title 44.
>
> (b) The complaint shall be filed within thirty (30) days after the mailing of notice of the final decision and shall set forth the reasons why the final decision is alleged to be erroneous and praying relief therefrom. The clerk of the court shall thereupon summon the division of taxation to answer the complaint.

CERTIFICATION

I hereby certify that on the 1st day of December, 2011 a copy of the above Decision and Notice of Appellate Rights were sent by first class mail, postage prepaid and return receipt requested to the Taxpayer's attorney at the address on file with the Division of Taxation and by hand delivery to Bernard Lemos, Esquire, Department of Revenue, One Capitol Hill, Providence, RI 02908.

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