STATE OF RHODE ISLAND AND PROVIDENCE PLANTATIONS

DIVISION OF TAXATION

ADMINISTRATIVE HEARING

FINAL DECISION AND ORDER

#2013-04

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.: 13-T-0002**
	:	**Historic Tax Credit**
Taxpayer.	:	

DECISION

I. INTRODUCTION

The above-entitled matter came for hearing pursuant to a Notice of Hearing and Appointment of Hearing Officer ("Notice") issued on January 23, 2013 to the above-captioned taxpayer ("Taxpayer") by the Division of Taxation ("Division") in response to the Taxpayer's request for hearing. A hearing was held on March 28, 2013. The parties were represented by counsel. A briefing schedule was set with briefs being timely filed by June 20, 2013.

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

Whether the Division correctly disallowed the Taxpayer's claim for a qualified rehabilitation expenditure ("QRE") pursuant to R.I. Gen. Laws § 44-33.2-1 *et seq.*

IV. MATERIAL FACTS AND TESTIMONY

Principal Revenue Agent, testified on behalf of the Division. She testified that she has been with the Division for 15 years with nine (9) years in the tax credit program which handles the historic, film, and scholarship tax credit programs. She testified that in April, 2012, the Rhode Island Historical Preservation and Heritage Commission gave a "part three certification" to the and forwarded said certification to the Division and she assigned it for an audit to . On cross–examination, she testified that the Taxpayer's organizational chart is a fairly standard organizational chart for those entities claiming historic credits. See Taxpayer's Exhibit One (1) (organizational chart).

Revenue Agent II, testified on behalf of the Division. She testified that she has been with the Division for eight (8) years with three (3) years in the tax credit program. She testified that her usual audit process for historic tax credits is to review the costs that a taxpayer has deemed as qualified and review the costs to determine if they are qualified, find out who incurred expenses, and ensure that expenses are correctly booked to a capital account as required. She testified that in a multi-phase project, if applicable, she ensures that expenses being claimed were not already claimed and/or denied in a prior phase of the project. In the , she testified there were two (2) owners: the who sold out of bankruptcy to so she audited both and She testified a

new owner can claim a prior owner's tax credits if the new owner can properly document the assignment of credit.

testified that the Division disallowed Taxpayer's claimed development fee of . She testified that at the time she reviewed the development fee, was the claimed developer of the project and was the claimed payor of the fee. She testified that she disallowed the fee for a variety of reasons including that she did not find any fee was incurred, has and had no employees, and the payee of the fee was and the owner of building was . She testified that had one (1) member which was so the company was paying itself. She testified that the development fee had not been paid in the past and the development services contract said the fee would be paid from available cash flow and if not, it would be paid in 12 years. She testified that she found that the development fee was a book entry and the salaried employees of performed all the work rather than the non-existent employees of

On cross-examination, testified that she has seen development fees claimed in excess of 10% of development costs. She testified that at the time of her audit, she had not seen the agreement which assigned the fee payment to the Taxpayer. See Taxpayer's Exhibit Three (3) (operating agreement of Taxpayer dated June 9, 2011). See also Taxpayer's Exhibit Five (5) and Division's Exhibit 27 (two (2) different copies of the development agreement with different Appendix B's).

The Taxpayer presented no witnesses.

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")[1] provides in part as follows:

Article V Application Guidelines
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4. Certifications of Rehabilitation
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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, 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.

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

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 Taxpayer argued that it has been assigned to pay the development fee (Taxpayer's Exhibit Three (3)) and the agreement fixed the amount of the fee and required its payment in full in 12 years. The Taxpayer argued that the agreement is a

binding obligation on the Taxpayer and the developer has legal recourse to pursue its right to payment from the Taxpayer if the Taxpayer breaches the obligation. The Taxpayer argued that it will have rental cash flow to pay the fee in full in ten (10) years (Taxpayer's Exhibit Two (2)) and its equity in its property is approximately so it has enough to settle any claim. See Division's Exhibit 43. The Taxpayer argued that even though the fee has not been paid, under the accrual method of accounting, an expenditure is incurred when liability can be established. The Taxpayer argued that the developer fee is a real fee and the Division is treating separate entities as a single entity when the entities are separate and the Taxpayer has a binding obligation to pay the fee.

The Division argued that it does not have a problem with inter-company transactions; however, at the time of the audit, the purported developer had no employees and the documents showed that the fee was to be paid from available cash flow with no binding obligation to pay until the twelfth year. See Division's Exhibit 27. In addition, the Division argued that the development agreement was between and was the only member of the so if a fee was to be paid it would be paid by to itself.

The Division argued that at hearing the Taxpayer presented new documents to show the project had a tenant to pay rent but the lease agreement was dated December, 2012 (Taxpayer's Exhibit Four (4)) which was after the audit determination was issued and the preliminary conference between the Division and Taxpayer held and the document indicated that the lease payments would not begin until 2013 with the development fee being paid from 2014 to 2023. The Division argued that it is not

opposed to inter-company transactions but QRE's are to be for the actual incurred costs and paid and not accrued costs that exist between companies that might never be paid.

D. Whether the Developer Fee is a QRE

R.I. Gen. Laws § 44-33.2-2(8) defines "qualified rehabilitation expenditure" ("QRE") 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, fair market value, a fixed liability, or an accrued cost.

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 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. By its own name, a QRE refers to money 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. Consistent with the statutory definition, as cited above, both Article V(4)(B) and Article VII of CR

08-13 allow the Division to rely on an Accountant's Certification[2] 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.[3]

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 actually incurred.

The companies' relationships and lack of employees and the appearance that the Taxpayer was paying a non-existent fee to itself raised questions on the part of the Division. However, the fact that parties may be related does not bar a taxpayer from requesting and receiving a QRE. The Taxpayer argued that the fee is now a fixed obligation and the Taxpayer has the legal obligation to pay the fee within 12 years to the developer and the developer has recourse against the Taxpayer if the fee is not paid.

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[2] 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.

[3] Thus, 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 $500,000 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 $200,000, the credit would be disallowed as materially inconsistent with the application.

Even accepting that the fee is now fixed,[4] there has been no expenditure. The Taxpayer admits it has not paid the fee but argued that it will be paying the fee.

The purpose of the statute - as demonstrated by its clear and unambiguous language – is 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 Taxpayer has not spent any money on development fees.

The Taxpayer argued that an Internal Revenue Service ("IRS") Technical Memorandum regarding a developer note for a low income project that was found to be substantial and non-contingent and thus eligible for a low-income housing credit was analogous to this matter. See Taxpayer's brief. The Taxpayer also relies on the fact that the IRS Code allows the accrual method as a permissible method for a taxpayer to compute income. In addition, the Taxpayer relied on *Brassard v. U.S.*, 183 F.3d 909 (8th Cir. 1999) which found that when using the accrual method of accounting, an expenditure is incurred when the liability is fixed and absolute but is not incurred when the liability is

[4] Appendix B for the development agreement given the Division indicated that the fee would be payable out of available cash but any remaining balance would be paid on the twelfth anniversary of the agreement. See Division's Exhibit 27. At hearing, the Taxpayer submitted the development agreement with a new Appendix B which is a schedule of the payments for the development fee. The second development agreement does not indicate that Appendix B had been amended and no evidence was introduced at hearing about the change to Appendix B in said agreement. The original Appendix B states that the fee "shall be in an amount not to exceed the maximum amount allowable under the applicable state and/or federal rehabilitation tax credit guidelines." The new Appendix B lists amounts due for development fees. The development agreement dated July 13, 2010 was assigned by the operating agreement (Taxpayer's Exhibit Three (3)) to the Taxpayer; though, it is unclear which Appendix B was assigned (or how the Appendix B was changed). Thus, while it is debatable whether the development fee is now a fixed liability as argued by the Taxpayer, for the purpose of this decision, it will be assumed that the fee is a fixed liability.

only contingent or conditional. In other words, the Taxpayer would agree that the original Appendix B was a conditional liability so could not be a QRE. But the Taxpayer believes that the second Appendix B and 2011 operating agreement evince a fixed liability which should be considered a QRE.

However, this matter revolves around the Rhode Island Historic Structures Tax Credit statute. The statute does not provide that the accrual method of accounting for the purposes of IRS income is to be used for determining a QRE. The statute does not provide that tax credits are to be given for liabilities. Rather, tax credits are to be given for actual expenditures.[5] See *Taxation Decision* 2011-21 (12/1/11).

VI. FINDINGS OF FACT

1. A Notice was issued on January 23, 2013 by the Division to the Taxpayer in response to its request for a hearing.

2. A hearing was held on March 28, 2013. Both parties were represented by counsel and briefs were timely filed by June 20, 2013.

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[5] 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 or to be paid.

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. 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 a 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 or accrued and the Division is to make such determinations if necessary.

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 denied.

Date: July 22, 2013

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:

__X__ ADOPT
_____ REJECT
_____ MODIFY

Dated: July 23, 2013

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 23rd day of July, 2013 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.

Lori Belasco