YEAR

CALIFORNIA FORM

1998 Research Credit 3523

Attach to your California tax return.

Name(s) as shown on return	Social security or California corporation number
	FEIN

Part I **Credit Computation.** Read the instructions before completing this form.

Section A **Regular Credit.** Skip this section and go to Section B – Alternative Incremental Credit, if you are electing the alternative incremental credit.

Line 1 through line 4 are to be completed only by corporations (other than S corporations, personal holding companies and service organizations). Individuals, estates or trusts and partnerships, begin on line 5.

1	Basic research payments paid or incurred during the income year. See instructions	1	
2	Base period amount. See instructions	2	
3	Subtract line 2 from line 1. If less than zero, enter -0-	3	
4	Multiply line 3 by 24% (.24)	4	
	Qualified research expenses paid or incurred.		
5	Wages for qualified services	5	
6	Cost of supplies	6	
7	Rental or lease costs of computers. See instructions	7	
8	Enter the applicable percentage of contract research expenses. See instructions	8	
9	Total qualified research expenses. Add line 5 through line 8	9	
10	Enter fixed-base percentage, but not more than 16% (.16). See instructions	10	%
11	Enter average annual gross receipts. See instructions	11	
12	Base amount. Multiply line 11 by the percentage on line 10	12	
13	Subtract line 12 from line 9. If zero or less, enter -0-	13	
14	Multiply line 9 by 50% (.50). See instructions	14	
15	Enter the smaller of line 13 or line 14	15	
16	Multiply line 15 by 11% (.11)	16	
17a	Regular credit. Add line 4 and line 16. If you do not elect the reduced credit under IRC Section 280C(c), enter the result and see the instructions	17a	
17b	Reduced regular credit (IRC Section 280C(c)). Multiply line 17a by: • 90.7% (.907) for individuals and estates or trusts; • 91.16% (.9116) for corporations; or • 98.5% (.985) for S corporations. Enter the reduced credit amount and write "Section 280C" on the dotted line to the left of the entry space	17b	

Section B **Alternative Incremental Credit.** Skip this section if you completed Section A – Regular Credit.

Line 18 through line 21 are to be completed only by corporations (other than S corporations, personal holding companies and service organizations). Individuals, estates or trusts and partnerships, begin on line 22.

18	Basic research payments paid or incurred during the income year. See instructions	18	
19	Base period amount. See instructions	19	
20	Subtract line 19 from line 18. If less than zero, enter -0-	20	
21	Multiply line 20 by 24% (.24)	21	
	Qualified research expenses paid or incurred.		
22	Wages for qualified services	22	
23	Cost of supplies	23	
24	Rental or lease costs of computers. See instructions	24	
25	Enter the applicable percentage of contract research expenses. See instructions	25	
26	Total qualified research expenses. Add line 22 through line 25	26	
27	Enter average annual gross receipts. See instructions	27	
28	Multiply line 27 by 1% (.01)	28	
29	Subtract line 28 from line 26	29	
30	Multiply line 27 by 1.5% (.015)	30	
31	Subtract line 30 from line 26. If zero or less, enter -0-	31	
32	Subtract line 31 from line 29. If zero or less, enter -0-	32	
33	Multiply line 27 by 2% (.02)	33	
34	Subtract line 33 from line 26. If zero or less, enter -0-	34	
35	Subtract line 34 from line 31. If zero or less, enter -0-	35	
36	Multiply line 32 by 1.32% (.0132)	36	

37	Multiply line 35 by 1.76% (.0176)	**37**	
38	Multiply line 34 by 2.2% (.022).	**38**	
39a	Alternative incremental credit. Add line 21, line 36, line 37 and line 38. If you do not elect the reduced credit under IRC Section 280C(c), enter the result and see instructions	**39a**	
39b	Reduced alternative incremental credit (IRC Section 280C(c)). Multiply line 39a by: • 90.7% (.907) for individuals and estates or trusts; • 91.16% (.9116) for corporations; or • 98.5% (.985) for S corporations. Enter the reduced credit amount and write "Section 280C" on the dotted line to the left of the entry space	**39b**	
40	Pass-through research credit(s) from S corporations, estates or trusts, partnerships and limited liability companies (LLCs) taxed as partnerships. See instructions	**40**	
41	Current year research credit. If you did not elect the reduced credit under IRC Section 280C(c), add line 17a **or** 39a to line 40 and enter the amount. If you elected the reduced credit under IRC Section 280C(c), add line 17b **or** 39b to line 40 and enter the amount	**41**	
42	Enter the amount of credit on line 41 that is from passive activities. If none of the amount on line 41 is from passive activities, enter -0-	**42**	
43	Subtract line 42 from line 41	**43**	
44	Enter the allowable credit from passive activities. See instructions	**44**	
45	Non-passive activity credit carryover from prior year. See instructions	**45**	
46	Total available research credit. Add line 43 through line 45. **Caution:** Your credit may be limited. See instructions for line 46.	**46**	

Part II Carryover Computation. Do not complete this part if you must file Schedule P (100, 540, 540NR or 541).

47	Amount of research credit claimed on current year tax return. See line 46 instructions	▶ **47**	
48	Credit carryover to future years. Subtract line 47 from line 46	**48**	

Instructions for Form FTB 3523

Research Credit

References in the form and instructions are to the Internal Revenue Code (IRC) as of **January 1, 1998,** and to the California Revenue and Taxation Code (R&TC).

General Information

A What's New

Conformity. In general, California tax law conforms to the Internal Revenue Code (IRC) as of January 1, 1998. However, there are continuing differences between California and federal tax law. California has not conformed to the changes made to the IRC by the federal Internal Revenue Service (IRS) Restructuring and Reform Act of 1998 (Public Law 105-206) and the Tax and Trade Relief Extension Act of 1998 (Public Law 105-277).

Alternative Incremental Credit. For taxable or income years beginning on or after January 1, 1998, the percentages for the 3-tiered credit rate used to figure the alternative incremental credit have been reduced to 80% of the federal percentages for the 3-tiered credit rate.

Qualified Research Expenses. For 1998 fiscal year taxpayers, qualified research expenses do not include any amounts paid or incurred on or after January 1, 1999, for tangible personal property eligible for the exemption from sales or use tax under R&TC Section 6378.

Classification. In 1998, the Franchise Tax Board (FTB) implemented the new principal business activity (PBA) code chart that is based on the North American Industrial Classification System (NAICS). However, the R&TC still refers to the Standard Industrial Classification (SIC) for purposes of qualifying for the research credit.

B Purpose

Existing companies and ''start-up'' companies use form FTB 3523 to figure and claim the research credit for increasing the research activities of a trade or business. Also use this form to claim pass-through research credits received from S corporations, estates or trusts, partnerships or limited liability companies (LLCs) taxed as partnerships.

S corporations, estates or trusts, partnerships and LLCs taxed as partnerships should complete form FTB 3523 to figure the amount of credit to pass through to shareholders, beneficiaries, partners or members. Attach this form to Form 100S, Form 541, Form 565 or Form 568. Show the pass-through credit for each shareholder, beneficiary, partner or member on Schedule K-1 (100S, 541, 565 or 568).

C Description

The credit is 11% of the excess of qualified research expenses for the taxable or income year over the base period research expenses. Corporations are allowed the 11% credit amount plus credit for 24% of the basic research payments.

Instead of the regular credit, taxpayers may elect the alternative incremental credit in which taxpayers are assigned a smaller 3-tiered fixed-base percentage and a reduced 3-tiered credit rate.

California conforms to the federal definition for qualified research expenses under IRC Section 41(b). For additional information on the federal definition, get federal Form 6765.

For payments made to certain nonprofit qualified research consortia, 75% (instead of 65%) of the payments are treated as qualified research expenses.

For 1998 California fiscal year taxpayers, qualified research expenses do not include any amounts paid or incurred on or after January 1, 1999, for tangible personal property eligible for the exemption from sales or use tax under R&TC Section 6378. The eligible property is tangible personal property used primarily:

1. In teleproduction or other postproduction services; or
2. To maintain, repair, measure or test any property described in 1.

D Limitations

The basic and qualified research must have been conducted within California.

If your business is conducted both within and outside of California, for purposes of determining the base amount, gross receipts are the receipts from the sale of property that is held primarily for sale to customers (in the ordinary course of your trade or business) and that is delivered or shipped to customers in California.

A husband and wife may claim only one credit. If separate returns are filed, the credit may be taken by either or divided equally between them.

S corporations may claim only 1/3 of the credit against the 1.5% entity-level tax after applying the limitations relating to passive activity losses and credits. If you are an S corporation claiming this credit, figure the credit at 100%. Multiply the credit figured on this form by 1/3 and transfer the amount to Schedule C (100S).

S corporations can pass through 100% of this credit to their shareholders on a pro rata basis. Partnerships must allocate the credit among the partners according to the partner's distributive share as determined in a written partnership agreement (R&TC Section 17039(e)).

If a taxpayer owns an interest in a disregarded business entity, the amount of the credit that can be utilized is limited to the difference between the taxpayer's regular tax computed with the income of the disregarded entity, and the taxpayer's regular tax computed without the income of the disregarded entity.

This credit cannot reduce the minimum franchise tax (corporations, limited partnerships, limited liability partnerships, LLCs and S corporations), the alternative minimum tax (corporations, exempt organizations, individuals and fiduciaries), the built-in gains tax (S corporations) or the excess net passive income tax (S corporations).

This credit can reduce regular tax below tentative minimum tax (TMT). See Schedule P (100, 540, 540NR or 541) for more information.

This credit is not refundable.

Note: This credit may be limited further. See IRC Section 41(g) and the line 17b instructions for details.

E Carryover

If the available credit exceeds the current year tax, the unused credit can be carried over to succeeding years until exhausted. Apply the carryover to the earliest taxable or income year(s) possible. In no event can this credit be carried back and applied against a prior year's tax.

Specific Line Instructions

Part I – Credit Computation

Section A – Regular Credit

Line 1 – Corporations (other than S corporations, personal holding companies and service organizations) may be eligible for a ''basic research'' credit if the 1998 payments in cash to a qualified university or scientific research organization (under a written contract) exceed a base period amount (based on your general university giving and certain other maintenance-of-effort levels for the 3 preceding years). To be eligible, the basic research must have been conducted within California.

Enter your 1998 payments on line 1. See IRC Section 41(e) and R&TC Section 23609(d) for details.

Biopharmaceutical and Biotech Research Activities
For income years beginning on or after January 1, 1996, corporations (other than S corporations, personal holding companies and service organizations) that are engaged in certain biopharmaceutical research and biotech research and development activities (as defined below) and that make payments to hospitals run by public universities (as defined below) or qualified cancer centers (as defined below) may be eligible to claim the ''basic research'' credit if they meet specific criteria.

The taxpayer's biopharmaceutical activities must satisfy both of the following:

- Meet at least one of the biopharmaceutical research activities described in Codes 2833 to 2836, inclusive or any research activities that are described in Codes 3826, 3829 or 3841 to 3845, inclusive of the Standard Industrial Classification (SIC) Manual published by the United States Office of Management and Budget, 1987 edition; and
- Use organisms or materials derived from organisms, and their cellular, subcellular or molecular components to provide pharmaceutical products for human or animal therapeutics and diagnostics. For biotechnology research and development, taxpayers must be involved in research and development activities regarding the application of recombinant DNA technology or pharmaceutical delivery systems.

If the taxpayer's activities meet the criteria mentioned in the paragraphs above and such payments are made to a cancer center, the cancer center must be a ''qualified cancer center'' which is defined as meeting all of the following criteria:

- Is both tax-exempt under federal law (IRC Section 501(a)) and owned by a tax-exempt organization (described in IRC Section 501(c)(3)); and
- Has been designated a ''specialized laboratory cancer center'' and has received Clinical Cancer Research Center status from the National Cancer Institute.

If the taxpayer's activities meet the criteria mentioned above and such payments are made to a hospital owned by a public university, the hospital must be an organization described in IRC Section 170(b)(1)(A)(iii), and the public university that runs such hospital must be an institution of higher education as described in IRC Section 3304(f).

Line 2 – Enter the base amount as defined in IRC Section 41(e) and R&TC Section 23609. If you do business both within and outside of California, see General Information D, Limitations. The amount on line 2 may not be more than the amount on line 1. This amount may be treated as 1998 contract research expenses on line 8 (subject to the 65% or 75% limitation).

Line 6 – See General Information C, Description, for information regarding qualified research expenses.

Line 7 – See IRC Section 41(b)(2)(A) for rules on leased computer property if you receive payments from anyone for the rental or lease of substantially identical property. Also see General Information C, Description, for information regarding qualified research expenses.

Line 8 – Include 65% of any amount paid or incurred for qualified research performed on your behalf. For corporations only, include 65% of the portion of line 1 basic research payments that does not exceed the line 2 base period amount.

For taxable or income years beginning on or after January 1, 1997, use 75% in place of 65% for payments made to a qualified research consortium. A qualified research consortium is a tax-exempt organization described in IRC Section 501(c)(3) or 501(c)(6) that is organized and operated primarily to conduct scientific research and is not a private foundation.

Line 10 – Compute the fixed-base percentage as follows:

Existing companies – The fixed-base percentage is the ratio that the aggregate qualified research expenses for at least 3 tax years from 1984 to 1988 bear to the aggregate gross receipts for such tax years. Round off the percentage to the nearest 1/100th of 1% (i.e., 4 decimal places).

Start-up companies – A start-up company is one that had **both** gross receipts and qualified research expenses either:

1. For the first time in a taxable or income year beginning after December 31, 1983; or
2. For fewer than 3 taxable or income years beginning after December 31, 1983, and before January 1, 1989.

The fixed-base percentage for a start-up company is 3% for each of the company's first 5 taxable or income years beginning on or after January 1, 1994, that the company has qualified research expenses. There is a 10 year phase-in period leading up to a credit based on 5 years of experience.

During the phase-in period, 3% continues to be used as the fixed-base percentage for a start-up company, but only during each of the company's first 5 taxable or income years beginning after 1993 for which it has a qualified research expense. For a start-up company's fixed-base percentage for its 6th through 10th years beginning after 1993, see IRC Section 41(c)(3)(B)(ii).

Note: The maximum percentage that can be entered on line 10 is 16% (.16).

Line 11 – Enter the average annual gross receipts for the 4 tax years preceding the tax year for which the credit is being determined (called the credit year). You may be required to annualize gross receipts for any short tax year. See IRC Section 41(c)(1)(B) and Section 41(f)(4) for details.

For purposes of line 10 and line 11, reduce gross receipts for any tax year by returns and allowances made during the tax year. In the case of a business that is within and outside of California, include only the gross receipts from the sale of property held primarily for sale to customers in the ordinary course of your trade or business that is delivered or shipped to customers in California, regardless of f.o.b. point or any other condition of the sale.

Line 14 – The base amount cannot be less than 50% of the current year qualified research expenses. This rule applies both to existing and start-up companies.

Line 17a – Unless you made an election to reduce the research credit, deductions under IRC Section 174 or any other deduction or credit provision for research expenses or basic research payments must be reduced by the amount of your current year's research credit.

Line 17b – S corporations, estates or trusts, partnerships and LLCs taxed as partnerships: The amount of research credit passed through to your shareholders, beneficiaries, partners or members is the pro rata or distributive share of the amount on line 17a multiplied by the shareholder's, beneficiary's, partner's or member's applicable credit reduction percentage shown below:

- 90.7% (.907) for individuals and estates or trusts;
- 91.16% (.9116) for corporations; or
- 98.5% (.985) for S corporations.

Note: In some cases, the pass-through entity may not know what type of entity the shareholder, beneficiary, partner or member is. In these cases, the pass-through entity will report the pro rata share or distributive amount of research credit on Schedule K-1 (100S, 541, 565 or 568) without the IRC Section 280C(c) reduction. The pass-through entity must note in the supplementary information section of the Schedule K-1 (100S, 541, 565 or 568) that the credit must be reduced by the shareholder's, beneficiary's, partner's or member's applicable credit reduction percentage.

Example 1: For the income year ended 12/31/98, ABC, Inc., an S corporation, generated $3,000 in research credit. ABC, Inc. elects the reduced research credit. ABC, Inc. figures its research credit as follows:

Step 1: $3,000 x 1/3 = $1,000
Step 2: $1,000 x 98.5% (.985) = $985

This amount is the research credit available to ABC Inc. for its 1998 income year.

Mark Smith is the sole shareholder (100%) in ABC, Inc. Mark materially participates in the business of ABC, Inc., holds no interest in any passive activity and does not have any non-passive activity credit carryover from previous years. The election by ABC, Inc. to the reduced research credit also applies to Mark and his 1998 pass-through research credit is figured as follows:

Step 1: $3,000 x 100% (1.0) = $3,000
Step 2: $3,000 x 90.7% (.907) = $2,721

This amount is the pass-through research credit available to Mark for his 1998 taxable year.

Example 2: Partnership AB has 2 partners each with 50% ownership. Partner A is an individual, and Partner B is a corporation. The partnership elects the regular reduced credit. The amount of regular credit figured by the partnership on line 17a is $2,000. Partnership AB would figure each partner's credit from the line 17a amount as follows:

Partner A – $2,000 x 90.7% (.907) x 50% (.50) = $907
Partner B – $2,000 x 91.16% (.9116) x 50% (.50) = $912

These amounts are the research credit available to Partner A and Partner B for their 1998 taxable or income years.

Note: Amounts received from S corporations, estates or trusts, partnerships and LLCs taxed as partnerships may be limited due to IRC Section 41(g) and the related regulations.

Section B – Alternative Incremental Credit

Complete this section ONLY if you are electing the alternative incremental credit instead of the regular credit. To be valid, the election must be made for the first taxable or income year beginning on or after January 1, 1997. Once made, the election applies to the current taxable or income year and all later years unless you receive Franchise Tax Board (FTB) consent to revoke the election.

Line 18 – Corporations (other than S corporations, personal holding companies and service organizations) may be eligible for a ''basic research'' credit if the 1998 payments in cash to a qualified university or scientific research organization (under a written contract) exceed a base period amount (based on your general university giving and certain other maintenance-of-effort levels for the 3 preceding years). To be eligible, the basic research must have been conducted within California.

Enter your 1998 payments on line 18. See IRC Section 41(e) and R&TC Section 23609(d) for details. Also see line 1 instructions for additional information.

Line 19 – Enter the base amount as defined in IRC Section 41(e) and R&TC Section 23609. If you do business both within and outside of California, see General Information D, Limitations. The amount on line 19 may not be more than the amount on line 18. This amount may be treated as 1998 contract research expenses on line 25 (subject to the 65% or 75% limitation).

Line 23 – See line 6 instructions.

Line 24 – See line 7 instructions.

Line 25 – Include 65% of any amount paid or incurred for qualified research performed on your behalf. For corporations only, include 65% of the portion of line 18 basic research payments that does not exceed the line 19 base period amount.

For taxable or income years beginning on or after January 1, 1997, use 75% in place of 65% for payments made to a qualified research consortium. A qualified research consortium is a tax-exempt organization described in IRC Section 501(c)(3) or 501(c)(6) that is organized and operated primarily to conduct scientific research and is not a private foundation.

Line 27 – Enter the average annual gross receipts for the 4 tax years preceding the tax year for which the credit is being determined (called the credit year). You may be required to annualize gross receipts for any short tax year. See IRC Sections 41(c)(1)(B) and 41(f)(4) for details.

For purposes of line 27, reduce gross receipts for any tax year by returns and allowances made during the tax year. In the case of a business that operates within and outside of California, include only the gross receipts from the sale of property held primarily for sale to customers in the ordinary course of your trade or business that is delivered or shipped to customers in California, regardless of f.o.b. point or any other condition of the sale.

Line 39a – See line 17a instructions.

Line 39b – See line 17b instructions.

Line 40 – Individuals, shareholders, beneficiaries, partners and members: If the S corporation, estate or trust, partnership or LLC taxed as a partnership elected the reduced research credit, the amount of research credit passed through to you on Schedule(s) K-1 (100S, 541, 565 or 568) should reflect a research credit amount in which the applicable credit reduction percentage has been applied. Your election of the credit reduction must be consistent with that of the pass-through entity. However, the credit reduction percentage may differ from that of the pass-through entity.

In some cases, the pass-through entity may not know what type of entity the shareholder, beneficiary, partner or member is. In these cases, the pass-through entity will report the pro rata or distributive amount of research credit on Schedule K-1 (100S, 541, 565 or 568) without the IRC 280C(c) reduction. The pass-through entity will note in the supplementary information section of the Schedule K-1 (100S, 541, 565 or 568) that the credit must be reduced by the shareholder's, beneficiary's, partner's or member's applicable credit reduction percentage as shown below:

- 90.7% (.907) for individuals and estates or trusts;
- 91.16% (.9116) for corporations; or
- 98.5% (.985) for S corporations.

The amount of research credit passed through to you on Schedule(s) K-1 (100S, 541, 565 or 568) may be limited due to IRC Section 41(g) and the related regulations. Specifically, the amount of credit entered on this line is limited to the amount of tax attributable to your interest in the proprietorship, S corporation, estate or trust, partnership or LLC taxed as a partnership generating the credit. Use the formula below to determine the credit limitation. If you have pass-through research credits from more than one business interest, figure the research credit limitation separately for each business interest by applying the formula below to each pass-through credit.

$$\text{Credit Limit} = \frac{\text{Taxable income attributable to your interest in the sole proprietorship or pass-through entity (Schedule K-1)}}{\text{Total taxable income for the year (Form 540, line 19; Form 540NR, line 19 or Form 541, line 20)}} \times \{\text{Net income tax}\}$$

For purposes of completing the above formula, **Net income tax** is regular tax (from Form 540, line 24; Form 540NR, line 27 or Form 541, line 21) plus alternative minimum tax (from Form 540, line 35; Form 540NR, line 44 or Form 541, line 26).

Note: The percentage representing taxable income attributable to your interest in the business to your total taxable income for the year cannot exceed 100%. If in the current taxable or income year you had no income attributable to a particular business interest, you cannot claim any research credit related to that business this year; however, the credit can be carried over to succeeding years until exhausted. Likewise, any current year pass-through research credit that exceeds the IRC Section 41(g) limitation may be carried over to succeeding years until exhausted. **Note:** All pass-through credit carryovers will be subject to the IRC Section 41(g) limitation in each subsequent year.

Line 44 – If any part of the amount on line 41 is from a passive activity, you must complete form FTB 3801-CR, Passive Activity Credit Limitations, or form FTB 3802, Corporate Passive Activity Loss and Credit Limitations, to determine your allowable credit. Complete form FTB 3801-CR or form FTB 3802, **(using California amounts)** before completing the rest of this form.

Line 45 – Enter any prior year research credit carryover **from non-passive activities only**. Any prior year research credit carryover from passive activities should have been included in the computation of allowable credits from passive activities (form FTB 3801-CR or form FTB 3802) on line 44. **Individuals, shareholders, beneficiaries, partners and members:** If the non-passive research credit carryover was generated from a pass-through entity, you must apply the IRC Section 41(g) limitation to the credit carryover before entering the allowable carryover on line 45. See the instructions for line 40 above on how to compute the IRC Section 41(g) limitation.

Line 46 – The amount of this credit you may claim on your tax return may be limited further. Refer to the credit instructions in your tax booklet for more information. These instructions also explain how to claim this credit on your tax return. You must use credit code number **183** to claim this credit. Also see General Information D, Limitations.