JANUARY/FEBRUARY 2001

CALIFORNIA FRANCHISE TAX BOARD

Tax News

State provides credit for child, dependent care expenses

Approximately 700,000 California taxpayers will qualify for a new refundable credit this year-- a credit that provides up to $907 for child and dependent care expenses.

The passage of Assembly Bill 480 established the new credit for household and dependent care expenses necessary for gainful employment. The credit is based on the federal child and dependent care expenses credit (see IRS Publication 503 for details).

We estimate that approximately 50,000 individuals who have no tax filing requirement will qualify to claim the credit and that $195 million will be paid to eligible filers as refunds or credits against tax due.

The credit is a percentage of the federal credit, depending on the taxpayer's California adjusted gross income (AGI). Here are the applicable percentages:

If the taxpayer's California AGI is $40,000 or less, the percentage of the

Continued on page 2

Filing portal open for e-business

As we reported last year in Tax News, we will offer taxpayers a new option for filing their personal income tax returns this year — the filing portal.

The new filing portal provides taxpayers with citizen-to-government electronic transactions that are direct, convenient and secure.

Here's how it works: Taxpayers who choose to file via the portal will use commercial software to prepare their returns. Participating tax preparation software companies will help customers transmit their data to us via an individual, online session.

The portal project was developed in close partnership with the tax preparation software industry and the National Association of Computerized Tax Processors (NACTP).

Customer service
Taxpayers who use the portal will be able to find out if we received their return and the status of their refund in two ways: they can use their commercial software to retrieve an acknowledgement (as with traditional e-filing), or they can log onto our website to view the acknowledgement information.

Note: We will provide customer support to taxpayers who have questions about portal filing, acknowledgements, etc. The software companies will answer customers' questions about the preparation of the tax return.

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Inside. . .

Tax News

Volume 00-1 January/February 2001

TAX NEWS is a bimonthly publication of the Communications Services Bureau, California Franchise Tax Board. Its primary objective is to provide information to income tax practitioners about state income tax laws, regulations, policies and procedures.

To update or correct your address or to subscribe to TAX NEWS (send $12 for a one-year subscription), write:
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www.ftb.ca.gov

For information about a client's account, contact:
Tax Practitioner Support Unit
(916) 845-7057 (phone)
(916) 845-6377 (fax)

For recorded answers to questions on California taxes, to order forms or to check on a refund, call:
(800) 338-0505
From outside U.S. (916) 845-6600

To send a facsimile about a client's account, transmit to:
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(916) 845-6377

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New refundable credit for child, dependent care expenses

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allowable federal credit which may be claimed is 63 percent.

If the California AGI is more than $40,000 but not more than $70,000, the percentage is 53 percent.

If the California AGI is more than $70,000 but not more than $100,000, the percentage is 42 percent.

Taxpayers with California AGI over $100,000 are not eligible for the credit.

The credit may be claimed on California Forms 540, 540A, 540NR and 540X. It cannot be claimed on Form 540 2EZ. To claim the credit, taxpayers must first calculate the allowable federal credit by completing either IRS Schedule 2441 for 1040 filers or IRS Schedule 2 for 1040A filers.

If you have clients who did not file a federal return or claim the federal credit, they can still claim the credit for California. First complete the federal Form 2441 (or federal Schedule 2 if your client filed form 1040A) to determine how much the federal credit would have been. Then follow the instructions provided with the California return to claim the credit.

To avoid delays in processing or denial of this credit, advise your clients to attach their completed federal schedule to their California return and to provide the following information:

- Federal Child and Dependent Care Expenses Form 2441 (Use federal Schedule 2 if you filed Form 1040A);
- social security number of each qualifying person; and
- name, address and taxpayer identification number (social security number or federal employer identification number) of the care provider. Note: If your client claims more than two qualifying individuals, add a statement to the return with the required information.

If we do not receive this information, we must deny the credit.

If a claim for the credit is denied, in certain situations we will allow the taxpayer 60 days to protest. Some of your clients could possibly receive a second billing before the 60-day protest period is past. If this happens, encourage them to respond as quickly as possible if they feel we have erroneously denied or reduced their credit.

This credit does not apply to all child care expenses. There are a number of tests and limits related to this credit, including:

- Qualifying Person Test;
- Keeping Up a Home Test;
- Earned Income Test;
- Work-Related Expense Test;
- Joint Return Test;
- Provider Identification Test;
- Earned Income Limit, and;
- Dollar Limit.

Please see IRS Publication 503 for details.

Call to hotline yields faster results than attaching letter to tax return

Special hotline here to help practitioners

The best way to receive specific answers to your clients' questions about their tax return or other information requiring timely action is to contact our Tax Practitioner Hotline at (916) 845-7057.

Don't attach a letter to your clients' tax return. Often these letters are not answered until they have traveled through our entire return processing process and are ultimately re-routed to the Taxpayer Service Center for reply.

This can take many weeks and sometimes the letters are inadvertently filed without a reply.

The only exception to this is if the letter provides an explanation for some information contained in the return.

In most cases, your questions can be immediately answered when you talk with a customer service representative from our Tax Practitioner Hotline on the telephone. If you need to furnish us with information, you can send it via fax to the Hotline.

Our average turn-around time for responding to fax queries is seven business days. Compare that to our typical 21day turnaround time for mail sent via the postal service.

Our Tax Practitioner Hotline is open from 8 a.m. to 5 p.m., Monday through Friday. You can send us a fax 24 hours a day, seven days a week, at (916) 845-6377.

Delivery services need correct FTB address

Please advise your clients that tax returns and correspondence addressed to our Butterfield Street address are at risk of being delayed, miss-sorted or returned to the sender because the United States Postal Service does not deliver mail to that street address.

If you or your clients need to use a private delivery service in order to file a return or to make timely payment, address it to:

Franchise Tax Board
Sacramento, CA 95827

Otherwise, use the address provided on our correspondence and publications.

You can find a list of mailing addresses in various California tax booklets, the California Package X and on our website at www.ftb.ca.gov/geninfo.

Key telephone numbers for practitioners only

We are redesigning the *Franchise Tax Board Information Directory* to make it easier to use and better aligned with tax practitioners' needs.

In the meantime, we urge you to take advantage of the many tax practitioner services we've implemented to aid you in doing business with us.

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Tax Practitioner Hotline	
Telephone	(916) 845-7057
Fax	(916) 845-6377
Personal Income Tax Collection	
Fax	(916) 845-0494
Business Entities Collection	
Fax	(916) 845-0145
FTB e-file Help Desk	
Telephone	(916) 845-0353

Ask the Advocate

Debbie Newcomb
Taxpayer Advocate

What should my clients do to terminate their corporation?

Once the corporation decides to terminate its existence or withdraw from doing business in California, they must file the following forms with the Secretary of State:

- *A Certificate of Dissolution (domestic); or*
- *A Certificate of Surrender (foreign); and*
- *Form FTB 3555, Assumption of Tax Liability/Request for Tax Clearance Certificate.*

And if their shareholder approval is less then 100 percent they must also file a *Certificate of Election to Wind up and Dissolve.*

When the Secretary of State receives the *Certificate of Dissolution* with *FTB Form 3555,* the corporation's powers, rights and privileges cease except for the purpose of winding up its affairs, and they will mail us the *Assumption of Tax Liability*. We will then either issue a tax clearance or notify the corporation what additional forms and or payments are necessary to obtain a tax clearance. The Tax Clearance

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Visit our new *Tax News* webpage

We've redesigned our *Tax News* webpage to meet your need for timely information.

Go to *Tax News Online* (www.ftb.ca.gov/education/taxnews/Index) to get the most current information affecting tax professionals.

Tax News Online is updated biweekly. For that reason, we recommend you visit the webpage often.

If you have questions about any of our *Tax News* products or services, call the *Tax News* Help Desk at (916) 845-7070.

Make sure your substitute, scannable forms are approved

Are you planning to use substitute or scannable 2000 California tax forms?

If so, please ensure that the tax forms meet our Substitute Forms Program requirements. Delays may occur during processing if these requirements are not met. In some cases, we may not be able to process your clients' forms and will have to contact them directly.

All companies that produce or sell substitute or scannable California tax forms must file an agreement to comply with our requirements for the 2000 tax year. Form FTB 1096, "Agreement to Comply with FTB Publication 1098," states that the company agrees to follow certain rules for developing substitute and scannable forms.

*Note: Merely **filing** form FTB 1096, however, does **not** mean we have approved the company's forms.*

Each year companies that produce substitute or scannable forms must submit their forms to us for approval. Companies that either sell or provide photocopies of official FTB forms do not need to submit them for approval. If you are unsure whether all your forms have been approved for the 2000 tax year, ask your software company to show you our letter of approval *for each form* before you use it.

Do not accept a general statement that the forms have been approved. Provide a list of forms you plan to use to the company and request a copy of the letter of approval for each form.

Here is a list of the companies that have filed forms FTB 1096 with us so far:

2nd Story Software, Inc.	(319) 373-3600
5227 Tax System, Inc.	(800)592-5227
Account Stationers & Printers	(800) 423-9717
AEI Fund Management, Inc.	Not Available
Alpha and Omega Solutions	(323) 930-0078
Alpine Data Inc.	(800) 525-1040
AM Software	(816) 741-7848
American Financial & Tax	(714) 669-1172
Arthur Andersen	(941) 341-1000
ATX Forms, Inc	(800) 944-8883
Block Financial Corporation	(800) 457-9525
CCH, Inc (Torrance)	(800) 457-7639
CCH, Inc. (Wichita)	(316) 612-5000
CFS Income Tax	(805) 522-1157
Content Creators, LLC	(415) 893-9915
CPA Software	(850) 434-2685
Creative Solutions	(800) 968-0600
Curtis Publications, Inc.	Not Available
Deloitte & Touche Tax Technologies	(847) 236-8000
Data Technology Group	Not Available
Drake Software	(828) 524-8020
EXACTAX Inc.	(800) 352-3638
File Your Taxes.Com	(805) 984-0248
Golden State Tax Training Institute, Inc.	(847) 459-3300
H&R Block, Inc	(816) 504-1188
Chase Hambrecht& Quist/Granite Ventures LLC	(415) 591-7700
H.D. Vest, Inc.	(972) 870-6000
HowardSoft	(858) 454-0121
Image One, Inc.	(818) 701-9692
Inland Society of Tax Consultants	Not Available
Intuit, Inc.	(858) 784-4274
ITS, Inc.	(800) 487-8291
Jackson Hewitt Tax Service	Not Available
Jones Lang LaSalle, Inc.	(312) 782-5800
KPMG LLP	Not Available
Lacerte	(858) 784-4274
Merrill Lynch	(212) 236-7303
Microsoft Corporation	(425) 703-7491
Micro Vision Software, Inc	(800) 829-7354
Nelco	(920) 337-2774
ORRTAX Software, Inc.	(800) 377-3337
Paul Cornish, E.A.	(909) 678-3561
Petz Enterprises, Inc.	(209) 835-2720
PLM International, Inc.	(415) 974-1399
Pro-BATE Software	(970) 336-5973
Professional Stationers, Inc.	(818) 982-5222

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Help us speed processing of amended tax returns

Amended personal income tax returns take longer to process, mainly because of their complexity and constraints in our automated processing systems.

Three of every four amended returns are manually processed and all amendments to nonresident returns are manually processed.

There are ways you can help us speed up the processing of your clients' amended returns:

- If you are amending a nonresident personal income tax return or amending *to* a nonresident status, complete a Form 540NR, California Nonresident or Part-Year Resident Income Tax Return, using the amended information and attach it to the Form 540X, Amended Individual Income Tax Return.
- Only file an amended return if an original return has been filed. This includes filing a Form 540X in response to a filing enforcement inquiry or assessment.
- Don't file an amended return just to make a payment.
- Be sure to use exactly the same taxpayer identification number(s) and names spelled in the same way as they are shown on the original return. But use the client's current address.
- Always enter the correct amounts in Column A – as originally reported or adjusted by FTB. If your client received a Return Information Notice or Notice of Tax Change (math errors), had a proposed assessment, or made a previous amendment, Column A should reflect these changes.
- Be sure to make the entries on line 7a, tax method used and 7b, tax.
- If you are not amending the withholding or excess State Disability Insurance amounts on the amended return, enter these amounts in exactly the same manner as on the original return. For example, if the amount was rounded on the original return and you use the exact dollars and cents on the amended (or visa versa) the return will be stopped in processing.

Scannable, Substitute Forms

Continued from page 5

Prudential Securities Incorporated	Not Available
Regents of the University of California, Los Angeles	(310) 794-8726
Rhodes Computer Services, Inc.	(706) 868-0985
RIA	(800) 327-8829
SDDS Computer Accounting	(909) 987-2408
Southern California Permanente Medical Group	Not Available
Spidell Publishing, Inc.	(714) 776-7850
Stallion Software, Inc.	(806) 467-9580
STF Services Corporation	(800) 541-7197
Tax and Accounting Software Corporation	(800) 998-9990
Tax Biz	Not Available
The Northern Trust Company	Not Available
Tax Link, Inc.	(614) 457-1949
Tax$imple, Inc	(800) 989-8955
Taxware Systems, Inc.	(800) 877-1065
Taxworks by Laser Systems	(801) 552-8800
Tri-Tech Software Developer Corporation	(972) 680-2223
Universal Tax Systems, Inc.	(800) 755-9473
Weaver Land Corp Tax Service	(408) 258-0912
XPRESS Group, Inc.	(800) 285-1065

Ask the Advocate

Continued from page 3

Certificate cannot be issued until the corporation has all of its forms filed and taxes paid.

The effective date of dissolution for a domestic corporation is the date on which Secretary of State receives the *Certificate of Dissolution*. The Secretary of State will forward *Form 3555*, to us and then notify the corporation that a conditional dissolution was granted which will become a formal dissolution when we issue a tax clearance for the corporation.

The effective date of withdrawal for a foreign corporation is the date on which the *Certificate of Surrender* is filed.

For additional information to terminate a corporation see *FTB Publication 1149, Terminating a Corporation*. The booklet is available on our website at www.ftb.ca.gov and can also be ordered by calling our Tax Practitioner Support Unit at (916) 845-7057.

Want to contact the Advocate?
Write to us at:
Taxpayer Advocate Bureau
MS B – 20
PO Box 157
Rancho Cordova, CA
95741-0157

Send us a fax at:
(916) 845-6614

Visit us on the Internet at:
www.ftb.ca.gov/
taxpayer_advocate.

FTB changes economic development area forms

We've made the following changes to our economic development area (EDA) tax forms and publications:

FTB 3807, Local Agency Military Base Recovery Area Deduction and Credit Summary and Publication 1102, Guidelines for Local Agency Military Base Recovery Area, now provides the following guidance:

To qualify for Local Agency Military Base Recovery Area (LAMBRA) tax incentives a taxpayer must be conducting business within a LAMBRA and the taxpayer must have a net increase in jobs. To satisfy the net increase in jobs requirement, the taxpayer must meet two tests:

- Full-time employees in California at the end of the second taxable year less full-time employees in California before commencing business in California must equal one or more.
- If the first test is met, the taxpayer must employ at least one full-time employee within the LAMBRA during each of the first two taxable years after commencing business operations within the LAMBRA.

FTB 3807 (1997-1999) and Publication 1102 (Rev 6/98) both detail the first test. Neither the booklet nor the publication addresses the second requirement.

FTB Pub 1102, General Information, fifth paragraph, will be updated to read:
In order to qualify for the LAMBRA tax incentives a business must have a net increase of one or more jobs within the first two taxable or income years of commencing business within *California*.

The 2000 tax forms and publications will reflect these corrections. For prior years (1997-1999) we will issue a statement referring customers to the 2000 forms for the proper calculation.

We also identified and corrected errors in our instructions for applying the apportionment formula (as provided by the statute) for calculating the EDA tax incentives.

The EDA tax incentives are limited to the amount of tax that would be imposed on the taxpayer's business income attributable to the EDA as if such income represented all the business income of the taxpayer.

This limitation is determined by using an apportionment formula as provided by the statute. For taxable years beginning on or after January 1, 1994 (for the LARZ) and January 1, 1998 (for all other EDAs), the apportionment formula is determined by multiplying the taxpayer's California apportioned business income by a fraction. The numerator is the taxpayer's EDA property divided by California property, plus EDA payroll divided by California payroll, divided by two as shown below:

EDA Business Income =

$$\frac{\dfrac{\text{EDA Property (TP)}}{\text{CA Property}} + \dfrac{\text{EDA Payroll TP)}}{\text{CA payroll}}}{2}$$

multiplied by:

EDA Taxpayer Apportioned Business Income

In 1997, we added an example to illustrate the above mentioned calculation. The example had two problems:

1. In the denominator (for EDA calculations) we used the combined groups California factors when we should have used the EDA taxpayer's California factors.
2. We used the combined groups CA apportioned income instead of the EDA taxpayer's CA intrastate apportioned income.

The errors were found in the following forms and publications:

- FTB 3805Z, Enterprise Zone Deduction and Credit Summary;
- FTB 3806, Los Angeles Revitalization Zone Deduction and Credit Summary;
- FTB 3807, Local Agency Military Base Recovery Area Deduction and Credit Summary;
- FTB 3808, Manufacturing Enhancement Area Credit Summary; and
- FTB 3809, Targeted Tax Area Deduction and Credit.

The incorrect example is also in the 1997, 1998, and 1999 versions of California Package X. The 2000 tax forms and publications, including the 2000 Package X will contain the corrections.

State has limit on mortgage interest deductions

The increase in recent years in the cost of California real estate has raised home valuations to record levels. These record home prices have resulted in an increase in the number of home mortgages in excess of $1,000,000.

Make your clients aware that California (through Revenue & Taxation Code Section 17201) conforms to the dollar amounts of the Federal Mortgage Interest Deduction Limitation (IRC Section 163).

We recently reviewed a sampling of Form 540 tax returns with large Schedule A mortgage interest deductions and found a 75 percent rate of non-compliance with the mortgage interest deduction limitation rules.

Here are some things to look for when calculating mortgage interest deductions:

- In general, a mortgage interest deduction is allowed for secured debts incurred to purchase a principal or second home and for home equity debts.

- The total amount of home acquisition indebtedness must not exceed $1,000,000, or $500,000 in the case of a married person filing separately, and the total amount of home equity indebtedness must not exceed $100,000, or $50,000 for a married person filing separately.

- Mortgage interest paid in excess of the limits stated above is generally considered non-deductible personal interest.

- The term *home equity indebtedness* means any indebtedness, other than acquisition indebtedness secured by that residence to the extent that the total amount of such debt does not exceed the fair market value of such qualified residence.

- The term *acquisition indebtedness* means any debt that is incurred in constructing, acquiring or substantially improving any qualified residence and in turn is secured by that residence.

- *Qualified Residence Interest* for California and Federal purposes allows for a Schedule A mortgage interest deduction as home mortgage interest to the extent the amount borrowed on the mortgage does not exceed the cost of the home (qualified principal or second residence), plus the cost of improvements.

- A *qualified residence* can be a house, condominium, cooperative, mobile home, house trailer, boat or other similar property that has sleeping, cooking and toilet facilities. Qualified residence means your main home, generally where you spend most of your time and/or a second home. Only one second home may be designated by the taxpayer for each year.

- Refinances of existing mortgages can present a mortgage interest deduction limitation concern if the amount refinanced by the taxpayer exceeds the cost of the home.

- Special rules apply to *grandfathered mortgage interest debt* incurred on or before October 13, 1987 which is not subject to the $1,000,000 mortgage interest deduction limitation. The refinancing of grandfathered mortgage interest debt should be reviewed to see if it triggers any mortgage interest limitation rules.

Please see *IRS Publication 936, Home Mortgage Interest Deduction*, which provides the details and definitions on this interesting topic along with a worksheet to calculate your deductible home mortgage interest for the year.

Economic Development Areas manual now online

Did you know that our Economic Development Areas (EDA) manual is available for viewing online?

The EDA manual is one of several in-house resources we put online. It provides technical guidance on the tax incentives associated with the economic development areas including Enterprise Zones, Local Agency Military Base Recovery Areas, Targeted Tax Areas and Manufacturing Enhancement Areas.

In fact, several of our internal procedure manuals online for practitioners and taxpayers are available for viewing or downloading from our forms and publications website located at www.ftb.ca.gov/manuals/index.htm.

Manuals you'll find there include our:

- Bank and Financial Handbook
- Collection Procedure Manual
- General Tax Audit Manual
- Multistate Audit Techniques Manual
- Water's Edge Manual

Note: The information provided in our internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.

FTB offers tips for completing Form 568

Here's a handy checklist to help you avoid some of the return preparation errors we routinely find in Form 568, Limited Liability Company (LLC) Return of Income.

Entity and return information, page 1

- Are both Accounting Period Beginning and Accounting Period Ending dates included at the top of the return?
- Are you using the correct form year? If the form year is not available, use the current year form and cross off the form year and indicate the year of filing. Use the proper fee schedule.
- Is the 12-digit Secretary of State identification number included? This should be the same number as that organized/registered through the California Secretary of State's office (SOS).
- Did you use the correct format when writing the 12-diget SOS identification number?

Here's the old format:
101996268018

10 = Record Type Identifier (internal)

CCYYJJJ = Cenury, Year and Julian the record was entered into the system.

ZZZ = Computer assigned sequential number for unique identification.

Here's the new format:
199626810018
CCYYJJJ = Cenury, Year and Julian the record was entered into the system.
1 = Record Type Identifier (internal)
ZZZZ = Computer assigned sequential number for unique identification.

- Is the LLC's full legal name included (no abbreviations)? Is punctuation exact? The name should be the same name as organized/registered through the SOS.
- Is the LLC's current address included?
- Is the principal business code, Line C at the top of the return correct?
- Is this a final return? If so, check the applicable box on Line I at the top of the return.
- Have all questions been carefully answered on page 1 Form 568?
- Is the total income on Line 1 equal to or greater than Schedule B line 1C?
- Is the corporation's payment information accurate? Line 6: Amount paid with form FTB 3537 and 2000 form FTB 3522; Line 7: Overpayment from prior year; Line 8: 2000 Nonresident Withholding Credit.
- If filing as a single member, has the appropriate information above the signature line been completed?

Other Information, page 2 and subsequent

- Is the Schedule T filled out correctly and has the information been brought over to Side 1, Line 4?
- Is the phone number listed?

Small Business Fairs

A small business fairs brings your government, at all levels together in one location to provide a full free day of counseling in areas that businesses need most.

These conferences benefit everyone: established businesses, those just getting started, individuals anticipating going into business, and those who participate in the accounting/taxation industry. Call the telephone numbers provided for information about a fair near you.

February 9, 2001
Los Angeles Small Business Fair
4800 Freshmen Drive
Culver City, CA
Phone (310) 342-1063
Fax (310) 342-1063
E-mail: lataxday@boe.ca.gov

March 2, 2001
San Diego
Point Loma Nazarene University
3900 Lomaland Drive
San Diego, CA
Phone (760) 744-6284, Ext. 410
Fax (760) 744-8057
E-mail: sdtaxday@boe.ca.gov

March 9, 2001
Long Beach/South Bay Small Business Tax Day
Long Beach Convention & Entertainment Center
100 South Pine Avenue
Long Beach, CA
Phone (310) 516-4330
Fax (310) 516-4139
E-mail: lbtaxday@boe.ca.gov

May 11, 2001
Bay Area Small Business Fair
Oakland State Building
1515 Clay Street
Oakland, CA
Phone (510) 622-4055
Fax (510) 622-4157
E-mail: basmbus@boe.ca.gov

FTB creates new return for water's-edge filers

A new tax return, Form 100W, has been developed for corporations that are computing their income under a water's-edge election.

A corporation that is a member of a unitary group of commonly-owned corporations is generally required to determine its California source income under the combined reporting method. The combined reporting group will include all of the corporation's worldwide unitary affiliates unless the corporation makes a *water's-edge* election to generally limit the group to those affiliates that operate in the United States.

In the past, corporations that made a water's-edge election filed the same Form 100 *Corporation Franchise or Income Tax Return* as other corporations, but attached a Form 2426 *Water's-Edge Coversheet* to the face of the return.

Beginning with the 2000 tax return, corporations (other than S corporations) making a water's-edge election or filing under a prior year's water's-edge election should no longer file the Form 100 return.

Instead, water's-edge electing corporations will file Form 100W, *California Corporation Franchise or Income Tax Return — Water's-Edge Filers*.

The Form 2426 coversheet no longer needs to be attached to the face of the return. (The new Form 100W should not be filed by S corporations. S corporations that have made a water's-edge election should continue to file the Form 100S and check the box on the face of the return to identify it as water's-edge.)

The new form will make it easier for taxpayers that want to make a water's-edge election to comply with the election requirements. It will also ensure that the water's-edge returns are properly processed.

The new Form 100W booklet was mailed at the end of December to corporations that filed under a water's-edge election last year. If you are making a new water's-edge election beginning in 2000 or did not receive a copy of the booklet in the mail, you can order the Form 100W by calling (800) 338-0505 or writing to Tax Forms Request Unit, Franchise Tax Board, P.O. Box 307, Rancho Cordova, CA 95741-0307.

The Form 100W can also be downloaded from the FTB website at (www.ftb.ca.gov/forms/index.htm).

It's not too late to order 2000 California Package X

Haven't ordered your 2000 California Package X yet? There's still time.

There are three versions of the 2000 Package X to choose from. The bound and loose-leaf paper versions cost $14 plus sales tax. The best value, however, is the CD-ROM for Windows version. It also costs $14 (plus sales tax) and comes with:

- 2000 California Package X forms
- 2000 Internal Revenue Service Package X forms
- Many fillable forms
- California Package X forms for the four previous years
- Information on electronic filing (e-file)

The CD-ROM (for Windows version) also has a search feature so that you can locate references to special words or terms in both the tax forms and instructions. And in March, you will receive a second disk with updated forms.

You should be able to use the CD-ROM if you have:

- A 486DX or Pentium computer with a processor speed of 33 megahertz or faster.
- Microsoft Windows "95," "98," "2000" or NT 4.0 (or later versions).
- Eight megabytes of RAM (main memory).
- Double speed or greater CD-ROM drive capable of reading ISO 9660 format.
- VGA, SVGA or higher resolution color video display/adapter.
- PostScript Windows-compatible printer or Hewlett-Packard LaserJet III and above with one megabyte of user RAM.

To order your Package X, contact the Tax News/Package X Helpdesk at (916) 845-7070.

Note: California residents ordering Package X must add sales tax to their total based on their county of residence.

Manufacturers' investment credit: Research and development activities

California allows a qualified taxpayer a manufacturers' investment credit (MIC) against tax equal to six percent of the qualified costs of certain property. In this article we discuss (1) qualified property used in the research and development (R&D) of new products and (2) whether product enhancements qualify for the MIC.

What's a qualified taxpayer?
A qualified taxpayer is any taxpayer engaged in an activity that is described in Division D, Manufacturing, of the Standard Industrial Classification (SIC) Manual, 1987 edition. Division D includes SIC codes 2011-3999. For tax years beginning on or after January 1, 1998, qualified taxpayer also includes certain activities described under SIC codes 7371-7373.
Generally, this means that a taxpayer must have, as part of its overall business operations, at least one business activity that is treated as a separate operating establishment and assigned a SIC code in Division D. The introductory section and appendices of the SIC Manual explain how to properly assign SIC codes to your business activities.

One error that taxpayers make is that they focus on whether their business activities are described in a Division D manufacturing activity without performing the classification analysis required by the SIC Manual. When the SIC code has properly been assigned using the classification principles discussed below, the taxpayer may find its SIC code is in another division of the SIC Manual, not manufacturing.

What are the SIC classification rules?
For purposes of determining whether the taxpayer is engaged in a qualified activity for the MIC, you must identify the establishments operated by the taxpayer. An "establishment," defined by the SIC Manual, is an economic unit, generally at a single physical location, where business is conducted or where services are performed. When taxpayers have more than one establishment, then each separate establishment needs to be analyzed independently. Business activities that are conducted at different locations are generally treated as separate establishments and assigned their own SIC code based on the principal activity being conducted at that location.

For example, if ***X*** manufactures stuffed toys in Los Angeles and operates a retail toy store in San Jose, each of these activities would be treated as separate establishments and assigned SIC codes 3942 and 5945, respectively.

In the case where multiple activities are conducted at a single location, such as manufacturing and R&D, the activities must be analyzed to determine whether they constitute separate establishments. The regulations provide that a business activity will be treated as a separate establishment if all of the following apply:

(1) No single industry description in the SIC Manual defines the combined business activities;
(2) Separate reports and financial statements are prepared for each unit; and
(3) More than 25 percent of the total number of employees or the dollar amount of payroll at that location is assigned to the separate business activity being tested.

If the employee or payroll numbers do not meet the 25 percent threshold, a taxpayer may still be able to prove that a separate establishment classification should be assigned based upon the facts and circumstances of the business operations.

Once the taxpayer's business activities have been broken down into "establishments," the next step is to determine the type of each establishment. Under the SIC Manual's classification principles, there are two types of establishments—*auxiliary* and *operating*.

Auxiliary establishments are defined as establishments that are primarily engaged in performing management or support services for other establishments (i.e., support functions). Some examples of activities commonly performed by these establishments are accounting, R&D, and testing.

Any establishment that is not treated as an auxiliary establishment is treated as an *operating establishment* and will be assigned a SIC code based on its principal activity.

Pursuant to the SIC Manual classification system, R&D establishments primarily engaged in research for other establishments in the same enterprise will always be classified as auxiliary establishments. For purposes of the MIC, the most significant consequence of an establishment being classified as an "auxiliary establishment" is that it is assigned the same SIC code as the "operating establishment" it supports. For example, if X's manufacturing

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Manufacturers' investment credit: Research and development activities

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activity is assigned SIC code 3555 and its R&D activity is properly treated as an auxiliary establishment that supports that manufacturing activity, then the R&D activity would also be assigned SIC code 3555.

Because the auxiliary establishment in this example is assigned the same SIC code as the manufacturing activity, any qualified property used in the R&D activity may qualify for the credit if the other MIC requirements are satisfied.

Where a taxpayer engages in R&D activity for both establishments in the same enterprise and third-party businesses on a contract or fee basis, special care must be taken in the analysis of the R&D activity. Establishments primarily engaged in commercial research and development for third parties, on a contract or fee basis, are assigned SIC code 8731 (Research, Development and Testing Services) outside of Division D, Manufacturing. As a result, these establishments are not qualified taxpayers for purposes of the MIC.

A taxpayer must carefully analyze the value of production for the R&D activity to determine the primary activity of an R&D enterprise, which provides both in-house and third-party contract research.

If the taxpayer has at least one business activity properly classified in Division D, manufacturing, then the taxpayer is a qualified taxpayer for purposes of the MIC.

What's qualified property?
The qualified taxpayer must place *qualified property* in service during the tax year in order to claim the MIC. Generally, qualified property is new or used tangible personal property (as defined in Internal Revenue Code (IRC) section 1245(a)(3)(A)) that is primarily (50 percent or more of the time) used by a qualified taxpayer in a qualified activity. Qualified activities include manufacturing, processing, refining, fabricating, recycling, pollution control or the maintenance, repair, measuring, or testing of otherwise qualified property, and R&D.

In order for a qualified taxpayer to claim the costs of qualified property used in an R&D activity, the taxpayer must meet the following three requirements:

1. The R&D activity must be classified as an auxiliary establishment that supports the qualified taxpayer's manufacturing activity described in Division D;
2. The taxpayer's research activity must be described in IRC section 174 and the accompanying regulations;
3. The costs for the property used in the R&D activity must be capitalized; and
4. The qualified property must be used primarily in the taxpayer's R&D activity.

What is research and development?
Treasury Regulation section 1.174-2(a) states that the term *R&D* means expenditures incurred in connection with the taxpayer's trade or business that represent R&D costs in the experimental or laboratory sense. The term *generally* includes all such costs incident to the development or improvement of a product. For example, R&D expenditures would include the costs of obtaining a patent, including any attorney fees expended in making and perfecting a patent application.

Additionally, expenditures represent R&D costs in the experimental or laboratory sense if they are for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product. For this purpose, uncertainty exists if the information available to the qualified taxpayer does not establish the capability or method for developing or improving the product, or the appropriate design of the product. Whether or not expenditures qualify as R&D expenditures depends on the nature of the activity to which the expenditures relate. It does not depend on the nature of the product or improvement being developed, nor does it depend on the level of technological advancement the product or improvement represents. The Treasury Regulation also defines the term "product" to include any pilot model, process, formula, invention, technique, patent, or similar property. It also includes products to be used by the taxpayer in its trade or business as well as products to be sold, leased, or licensed.

For purposes of IRC section 174, the R&D expenditures can either be currently deducted or amortized. The taxpayer makes an election to deduct or capitalize R&D expenditures on a project-by-project basis. To qualify for the MIC, the taxpayer must elect to capitalize the item of qualified property. Any item that is expensed will not qualify for the credit since it is not

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Portal

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Security
Our portal will use the most current encryption software available for the transmission of the return and retrieval of the acknowledgment.

Future expansion
This year our filing portal will be limited to taxpayers. We plan to expand it to tax practitioners and third party transmitters as early as 2002.

Contact your software provider to see if they're going to offer the portal option in 2002.

Look for updates about the filing portal and other E-government initiatives on our E-Government webpage located on the Internet at www.ftb.ca.gov/other/index and in Tax News.

MIC

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"properly chargeable to a capital account."

The MIC regulations provide several examples involving qualified property used in R&D activities for new product development and enhancement. For instance, California Code of Regulations, title 18, section 23649-5(b)(4), example 13, states:
W, a qualified taxpayer, manufactures engines for propeller airplanes in Long Beach. ***W*** constructs two engine test stands. The first engine test stand is used to evaluate design enhancements to the engines manufactured by ***W***.

Assuming this first engine test stand is tangible personal property that is defined in IRC Section 1245(a)(3)(A), and assuming ***W's*** research activity is described in IRC Section 174 or the regulations thereunder, ***W*** may treat the first engine test stand as qualified property because it is used in R&D.

The second test stand is used to evaluate and test assembled engines prior to their shipment to customers. Assuming this second test stand is tangible personal property that is defined in IRC Section 1245(a)(3)(A), ***W*** may treat the second engine test stand as qualified property because it is used as part of ***W***'s manufacturing process.

In this example, the R&D activity relates to design enhancements to the product manufactured by the taxpayer. This is product-related R&D and to the extent described in IRC section 174, the R&D activity is a qualified activity for the MIC. Accordingly, assuming *all* of the other requirements for the MIC are satisfied, tangible personal property utilized in the R&D activity constitutes qualified property for purposes of the MIC.

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