9000 TAX CREDITS

Once the proper tax rate is applied to California net income, tax credits are subtracted in determining the proper tax under California law. The rules for determining tax credits are very detailed, and frequently the rules will change from year to year. An in-depth discussion of the specific rules for each credit is beyond the scope of this manual. Instead, this section of the manual is intended only to provide a general overview of many of the available credits. If you are examining tax credits refer to the specific statute for the credit and the year involved.

9010 GENERAL INFORMATION

Tax credits must reduce tax in the following order (R&TC §23036(c)):

- Credits, which cannot be carried over
- Credits, which can be carried over
- Alternative Minimum Tax credit (see MATM 8580)
- Credits for taxes withheld.

Credits cannot reduce tax below the minimum franchise tax. Additionally, only the credits specifically listed in R&TC §23036(d)(1) may reduce regular tax below the tentative minimum tax, and then only after the alternative minimum tax credit has been allowed. In the *Appeal of NASSCO Holdings, Inc.*, 2010-SBE-001, November 17, 2010, the Board of Equalization allowed the Enterprise Zone Credit (EZ) and the Manufacturers' Investment Credit (MIC) to reduce AMT. See FTB Notice 2011-02. Therefore, the EZ, MIC, and carryovers from certain repealed versions of the solar energy credit are allowed to offset the AMT.

Generally, the amount of credit that exceeds the minimum franchise or the tentative minimum tax may be carried over to offset tax in subsequent years. A credit may be carried over regardless of whether the statute providing for the credit has expired or been repealed.

For tax years beginning before 1/1/2008, unless otherwise specified in the statute, tax credits may only be claimed by the taxpayer incurring the cost (*Appeal of AeroVironment, Inc*.,97-SBE-001, Jan. 10, 1997)(As of January 1, 1992, if two or more taxpayers share in the costs, then each taxpayer may claim the tax credit in proportion to the costs paid or incurred. (R&TC § 23036(g).)

For taxable years beginning prior to 7/1/2008, unless specifically stated otherwise (i.e., low-income housing, Enterprise Zone wage and LAMBRA wage credits), corporations that are members of a combined unitary group must compute credits and apply the credit carryovers on a separate basis. You should determine the allowable tax credits of a combined taxpayer through intrastate apportionment. (See MATM 7900 for an explanation of intrastate apportionment.)

SOL Considerations for Credit Carryovers:

By the time that a credit carryover is used, the statute of limitations has often expired for the prior year in which the tax credit was generated. An expired SOL will not bar you from examining the prior year credit in order to determine the effects on the open years. If a material credit was not thoroughly reviewed in the year that it was generated, you should review the year that the carryover results in a tax effect.

R&TC section 19043.5 authorizes FTB to issue a Notice of Proposed Adjusted Carryover Amount (NPACA) when an examination results in a reduction of a taxpayer's reported carryover amount. NPACAs are treated as if they are proposed deficiency assessments (NPAs) and the taxpayer receives protest and appeal rights even though the exam does not result in any additional tax. (MAP 7.7)

Business Tax Credit Limitations

For tax years beginning on or after 1/1/2008 and before 1/1/2010, there is a limitation on the application of business tax credits for corporate taxpayers with income subject to tax of $500,000 or more. The limitation is equal to 50 percent of the net tax before the application of credits.

Business tax credits disallowed due to the 50 percent limitation may be carried over. The carryover period for disallowed credits is extended by the number of taxable years the credits were not allowed. Taxpayers are required to keep track of the disallowed business tax credits on a worksheet and provide it to you upon request.

Repealed Credits

There are several credits that have expired but contained carryover provisions that are not covered in this manual. There are no longer separate credit forms, but the taxpayer must keep the old tax returns along with the appropriate information to substantiate that it is entitled to the credits. You can request information even on tax returns for years that are past the statute of limitations.

9015 CREDIT ASSIGNMENT

For taxable years beginning on or after July 1, 2008, R&TC §23663 allows the assignment of credits among members of the same combined report. Assigned credits can be used to offset tax of the eligible assignee in taxable years beginning on or after January 1, 2010.

Credits available for assignment are any credits under Chapter 3.5 (tax credits commencing with section 23604) generated by the assignor beginning on or after July 1, 2008 and any credits eligible to be carried forward to the assignor's first taxable year beginning on or after July 1, 2008. The Prior Year Alternative Minimum Tax Credit is excluded from the eligible credits because it falls under Chapter 2.5 (commencing with section 23400). For a list of the eligible credits, see credit chart in the Form 100 and 100W booklets.

Assigning or Receiving Credits

The assignor of the credit is the taxpayer that originally generated the eligible credit or is allowed the credit as a distributive share item. The election to assign credits is made on the original return for the taxable year of the assignment. To elect to assign credits, the assignor submits FTB 3544 with its original return. This election is irrevocable. Assignor cannot file an amended return to elect, modify, revoke, or change its assignment.

The eligible assignee is any affiliated corporation that is a member of the same combined reporting group (under CCR §25106.5) as the assignor on both of the following dates under either of the two scenarios:

- June 30, 2008 and the last day of the taxable year in which the credit was assigned to the assignee. This is for credits generated in taxable years before July 1, 2008 that are being carried over by the assignor, or
- The last day of the taxable year in which the credit was first allowed to the assignor and the last day of the taxable year in which the credit was assigned to the assignee. This is for credits generated in taxable years beginning on or after July 1, 2008.

Assigned credits can be used to offset an assignee's tax liability for taxable years beginning on or after January 1, 2010. Assignee attaches FTB 3544A to its original return to use the assigned credits against its tax liability. Any eligible credit can only be assigned once. The assignee cannot reassign the same credit. An assignor cannot assign or allocate a specific portion of any credit, or reference to a particular asset or employee upon which earning of the credit is based. The credit is assigned solely by reference to a specific dollar amount for each year.

Credit Limitations or Restrictions

Limitations on the use of the tax credit that would have applied to the assignor will also apply to the assignee. This includes credit expiration dates, Enterprise Zone income limitation requirements, any IRC §383 limitations, single member limited liability company (SMLLC) income requirements, or any other limitations on the allowance of the tax credit that would have applied to the assignor.

Expiration dates

Assigning a credit does not extend or change the carryover period. The same credit carryover expiration date that applies to the assignor also applies to the assignee. For example, if a credit carryover expires for the assignor in 2015, it will expire for the assignee in 2015. If the assignee is not able to use the credit before the expiration date, the credit is no longer available to offset tax.

EZ Credits

The assignee is subject to the income limitations applicable to the eligible assignor with respect to the same enterprise zone for which the credit was generated. This means the assignee must have income from the same zone for which the credit was generated by the assignor. To determine the amount of credit allowed to reduce tax, the assignee must look to its own income attributable to the enterprise zone, based on its own factors, in the year the assignee seeks to use the EZ credit. If the assignee generates its own EZ credit from the same zone that generated the assigned credit, the assignee does not compute two EZ income limitations. The assignee only computes one EZ limitation based on the EZ factors for the year the assignee is using the credit, whether the credit was originally generated by the assignee or was received via an assignment.

Research Credit

The assignee does not need to be engaged in a qualified research activity to receive or use the R&D credit.

SMLLC Limitations

The limitations provided in R&TC §23036(i) apply to the assignee. Under R&TC §23036, the amount of credit which may be applied against tax is limited to the amount of the owner's regular tax attributed to the income of the SMLLC. To compute the section 23036(i) limitation, the assignee should be the owner of the SMLLC. For more information regarding the limitation, see the credit assignment FAQs.

Other Assignment Provisions

Other provisions allow the assignment of credits. R&TC §23610.5(q) allows Low Income Housing Tax Credit assignment and R&TC §23685 allows California Film and Television Tax Credit assignment. The credit assignment provisions under R&TC §23663 do not over ride the assignments made under R&TC §23610.5(q) and 23685. Instead, they simply provide alternative permissible mechanisms under which to assign a credit. See R&TC §§23610(q) and 23685 for their respective governing rules regarding what may be assigned and to whom. These other sections must be examined if an assignment is made under one of them rather than under R&TC §23663.

Purchase of Assigned Credits

If an agreement between the assignor and the assignee includes compensation or remuneration to receive the credit assignment, there are no tax consequences for California purposes. No deduction is allowed to the assignee and no amount received is included in the gross income of the assignor. However, there may be federal income tax consequences.

Adjustments to the Assigned Credits

The assignment of credits is an irrevocable election made on the assignor's original return. The original return is the last return filed on or before the due date (taking extensions into account) or, if no return is filed by that date, the first return filed after such date. The assignor and the assignee are jointly and severally liable for any tax, addition to tax, or penalty resulting from the disallowance of any eligible credit. Any disallowance of the credit, including credit carryovers will be considered on a case-by-case basis.

9030 CHILD CARE CREDIT

Credit for Start-Up Costs

Per R&TC §23617, for each taxable beginning on or after January 1, 1988, and before January 1, 2012, a credit is allowed for the start-up expenses of establishing a child care program or constructing a child care facility in California, to be used primarily by the children of the taxpayer's employees. The credit is 30 percent of any of the following:

- The cost paid or incurred by the taxpayer on or after 9/23/88, for the startup expenses of establishing a child care program or constructing a child care facility in California, to be used primarily by the children of the taxpayer's employees.
- For taxable years beginning on or after 1/1/93, the cost paid or incurred by the taxpayer for startup expenses of establishing a child care program or constructing a child care facility in California to be used primarily by the children of employees of tenants leasing commercial or office space in a building owned by the taxpayer.
- The cost paid or incurred by the taxpayer on or after 9/23/88, for contributions to California child care information and referral services, including, but not limited to, those that identify local child care services where vacancies are available.

The amount of the credit cannot exceed $50,000. Refer to Legal Ruling 93-2 for examples of the credit limitation.

No deduction is allowed for expenses paid or incurred for the taxable year which is equal to the amount of the credit allowed. Alternatively, the taxpayer may elect to take depreciation instead of a credit.

Child Care Contribution Credit

The Employer Child Care Contribution Credit is allowed for a percentage of the cost paid or incurred for contribution to a qualified plan. Per R&TC §23167.5, for taxable years beginning on or after January 1, 1995, and before January 1, 2012, a credit is allowed for costs paid or incurred by the taxpayer for contributions to a qualified plan made on behalf of any qualified dependent of the taxpayer's qualified employee. The credit is 30 percent of the cost paid or incurred. The cost cannot exceed $360 for each qualified dependent. There is no comparable federal credit.

If an employer makes contributions to a qualified care plan and also collects fees from parents to support a child care facility owned and operated by the employer, no credit is allowed to the extent the sum of contributions and fees exceeds the total cost of providing care. You may require information about fees collected from parents of children served in the facility from taxpayers claiming credits under this section.

For tax years beginning on or after January 1, 2001, contributions do not include any amounts contributed to a qualified plan pursuant to a salary reduction agreement to provide benefits under a dependent care assistance plan.

Any unused credit may be carried over to the following year, and succeeding years if necessary, until the credit has been exhausted.

No deduction is allowed for that portion of expenses paid or incurred for the taxable year that is equal to the amount of the credit allowed under this section.

This credit cannot reduce

- Alternative minimum tax
- Minimum franchise tax
- Built-in gains tax (S corporations)
- Excess net passive income tax (S corporations)

Definitions

"Qualified care plan" means a plan providing qualified care.

"Qualified care" includes, but is not limited to, onsite service, center-based service, in-home care or home-provider care, and a dependent care center as defined by section 21(b)(2)(D) of the Internal Revenue Code that is a specialized center with respect to short-term illnesses of an employee's dependents. "Qualified care" must be provided in this state under the authority of a license when required by California law.

"Contributions" include direct payments to child care programs or providers. "Contributions" do not include amounts contributed to a qualified care plan pursuant to a salary reduction agreement to provide benefits under a dependent care assistance program within the meaning of section 129 of the Internal Revenue Code, as applicable, for purposes of Part 10 (commencing with Section 17001) and this part.

"Qualified employee" means any employee of the taxpayer who is compensated for performing services for the taxpayer in this state, within the meaning of R&TC section 25133, during the period in which the qualified care is performed.

"Employee" includes an individual who is an employee within the meaning of IRC §401(c)(1) (relating to self-employed individuals).

"Qualified dependent" means any dependent of a qualified employee who is under the age of 12 years.

The credit is not available if the employee's dependent is in the care of a person who:

- Qualifies as a dependent or the employee or that employee's spouse.
- Is a son, stepson, or stepdaughter, of the employee and is under the age of 19 at the close of the tax year.

Prior Law

For taxable years beginning before January 1, 1995, the credit was 50 percent of eligible costs with a maximum of $600 per qualified dependent under the age of 15.

9050 DONATED AGRICULTURAL PRODUCTS CREDIT

Pursuant to R&TC §23608, for taxable years beginning on or after January 1, 1996, a credit is allowed in an amount equal to 50 percent of the transportation costs paid or incurred by the taxpayer in connection with the transportation of any agricultural product donated to a nonprofit organization.

The nonprofit organization is required to provide the taxpayer a certificate containing the donor's name, the type and quantity of product donated and the donee's name and address. You should request this certificate when examining the credit.

The taxpayer must reduce any deduction that would otherwise be allowed by the amount of the credit claimed. Since there is no comparable federal credit, a state adjustment may be required. (See MATM 6055.)

The credit may not reduce tax below the tentative minimum tax, but may be carried forward until exhausted.

Prior Law

For years 1989 through 1991, a credit is allowed for agricultural products donated to nonprofit organizations. The credit is equal to 10 percent of inventory costs, defined under IRC §263A, and includes farming operations.

9060 ECONOMIC DEVELOPMENT AREA TAX CREDITS

California currently has four types of Economic Development Areas (EDAs) that have related tax incentives:

- Enterprise Zones (EZs)
- Local Agency Military Base Recovery Areas (LAMBRAs)
- Manufacturing Enhancement Areas (MEAs)
- The Targeted Tax Area (TTA)

Taxpayers who conduct business activities within the boundaries of one of these areas or zones qualify for the hiring credit, sales and use tax credit and other tax incentives.

In prior years, special tax incentives were also available for taxpayers that conducted business activities within the boundaries of the former Los Angeles Revitalization Zone

(LARZ), Program Areas and expired Enterprise Zones. The LARZ incentives applied to taxable years beginning on or after January 1, 1992, and before January 1, 1998. The Program Area incentives applied to taxable years beginning on or after January 1, 1985, and before January 1, 1997. For taxable years beginning on or after January 1, 1997, Program Areas were converted to EZs and are entitled to the benefits available to EZs. Over the years, a number of EZs have expired.

For more information about the EDA tax incentives, go to the EDA Manual.

9110 LOW-INCOME HOUSING CREDIT

California allows a tax credit against tax for construction or rehabilitation of low-income housing in California (R&TC § 23610.5). The credit is equal to 30 percent of amounts invested and is claimed over four years. To qualify for the state credit, a taxpayer must receive an allocation from the Tax Credit Allocation Committee, and the rents must be maintained at low-income levels for 30 years. This section discusses the areas where California law differs from federal. Whether or not the IRS has examined the federal credit, you should examine these areas.

- The low-income housing project must be located in California.
- The credit must be allocated and authorized by the California Tax Credit Allocation Committee (CTCAC).
- The CTCAC must have authorized a federal credit to the taxpayer or the taxpayer must qualify for the credit under IRC §42(h)(4)(B).)

The taxpayer is not required to attach form CTCAC 3521A, Certificate of Final Award of California Low-Income Housing Tax Credits, to the return. However, it must retain the certificate and make a copy available to you upon request.

California allows the credit to be claimed over a four-year period, not ten years as required under federal law. The applicable percentage of cost for computing the credit has changed over the years. In addition, the applicable percentage may depend on the highest federal rate and if the project is federally subsidized. You should refer to R&TC §23610.5 and IRC §42 when verifying the credit computation.

An additional credit may be claimed if the basis of a low-income housing building has increased since the CTCAC allocated the original credit. The CTCAC must authorize the additional credit.

California does not conform to the federal provision that allows the owner of a low-income housing unit occupied entirely by full-time students to qualify for the credit

There is no California provision similar to the federal provision that allows an election to claim 150 percent of the credit in the first year ending after October 24, 1990.

California requires a 30-year "compliance period", whereas the federal law only requires 15 years. The California law contains no provision, similar to the federal provision, for recapture of the credit if a project owner fails to comply with restrictions during the compliance period.

For tax years beginning on or after 1/1/2009 and before 1/1/2016, the credit shall be allocated to the partners of a partnership owning the project in accordance with the partnership agreement, regardless of how the federal low-income housing tax credit with respect to the project is allocated to the partners, or whether the allocation of the credit under the terms of the agreement has substantial economic effect, within the meaning of IRC §704(b)

Farmworker Housing

For taxable years beginning on or after January 1, 2009, the farmworker housing credit has been consolidated into the low-income housing tax credit.

Prior to 1/1/2008, unlike most credits, which may only be claimed by the entity incurring the costs, any portion of this credit may be assigned to one or more affiliates by election of the taxpayer. However, the affiliate must be 100 percent commonly owned. Once the election is made it is irrevocable for the year the credit is claimed, but the election may be changed in subsequent years. This credit assignment provision is effective for taxable years beginning on or after January 1, 1993. (R&TC §23610.5(q); formerly (r).)

The credit may reduce tax below the tentative minimum tax and may be carried forward until exhausted. The California credit remains in effect as long as the federal credit does. In 1993, the federal credit was extended indefinitely.

9120 MANUFACTURERS' INVESTMENT CREDIT

To stimulate employment in California, the State Legislature enacted three provisions to alleviate the basic sales tax for manufacturing companies on purchases of manufacturing equipment. Sales and Use Tax Code §6377 provides a partial sales tax exemption for new manufacturing companies equal to 5 percent of the 6 percent basic sales tax. As an alternative to the partial sales or use tax exemption, qualified taxpayers may claim a credit against tax on the California income or franchise tax return under R&TC §23649. Or, in lieu of claiming the sales tax exemption or the income of franchise tax credit, Sales & Use Tax Code §6902.2 allows taxpayers to file a claim for refund with the Board of Equalization for the sales and use tax paid. The refund is an amount equal to the income or franchise tax credit that would have been allowed to offset the current year tax liability. The refund may be claimed on or after the date the taxpayer would have been able to claim the credit on the income or franchise tax return.

Generally, a “qualified taxpayer” is allowed a manufacturers’ investment credit (MIC) equal to 6 percent of the “qualified costs” paid or incurred for “qualified property” that is placed in service in California. Qualified Taxpayer, Qualified Property and Qualified Costs are the three requirements for claiming the MIC. All three must be met for the taxpayer to claim the credit. Each of the MIC qualification requirements is discussed below.

As stated in FTB Notice 2003-10, the California Legislative Counsel issued a written opinion dated June 17, 2003, that the MIC statute has been repealed by its own terms and ceases to be operative as of January 1, 2004. Therefore, the rules only apply to credit carryovers from tax years ending in 2003 and earlier.

Qualified costs for the MIC are limited to those costs paid or incurred during the operative dates of the MIC statute. Therefore, all costs paid or incurred during the operative dates of the MIC statute for qualified property that is placed in service prior to January 1, 2004, may be qualified costs for purposes of the MIC. Conversely, for property that is placed in service on January 1, 2004, or thereafter, none of those costs will be qualified costs for purposes of the MIC because a taxpayer is not eligible to claim the MIC until the property is placed in service in this state.

Definitions

Qualified Taxpayer

A "qualified taxpayer" for purposes of the MIC is any taxpayer that is engaged in an activity described in Division D (Manufacturing) of the Standard Industrial Classification (SIC) Manual, 1987 edition (SIC Code 2011- SIC Code 3999). A taxpayer with multiple business activities that are treated as "establishments" under the SIC Manual will be a qualified taxpayer if any one of its activities falls within SIC Code 2011- SIC Code 3999.

In addition, for taxable years beginning on or after January 1, 1998, the definition of "qualified taxpayer" is expanded to include any taxpayer engaged in activities related to computer programming services or computer software design, SIC Code 7371 - SIC Code 7373.

The FTB Form 3535 instructions contain a condensed listing of manufacturing activities, which are classified under SIC Code 2011- SIC Code 3999. The SIC Manual describes and uses "establishments" to classify business activities into the various SIC codes. Examples of whether an activity constitutes an "establishment" can be found in CCR §23649-3. See the SIC Manual for a complete listing and the rules for determining classification of the SIC codes. The SIC Manual is available at https://www.osha.gov/pls/imis/sic_manual.html

In *Save Mart Supermarkets & Subsidiary*, 2002-SBE-002, February 6, 2002, the SBE addressed the 'qualified taxpayer' issue and held the activities of a full-service bakery and meat-processing department operating within a grocery store served to qualify the grocery store as a qualified taxpayer for purposes of the MIC. In *Save Mart*, the taxpayer showed it was engaged in activities described in Division D (codes 2011 to 3999, plus codes 7371-7373 after January 1, 1998) of the SIC manual. In addition, in *Save Mart,* the SBE found the meat and bakery operations were more than a trifling or irrelevant segment of its overall operations. The qualifying activity must be a significant part of the overall operations of the business.

In 2005, the SBE again addressed the matter in an unpublished decision *Appeal of Safeway, Inc. The Vons Company Inc.* The Board again held for the taxpayer, finding Safeway was a qualified taxpayer, but further stated, "we therefore observe that, although our *Save Mart* opinion serves as a precedent in other matters involving the same facts (i.e. other grocery stores with meat and bakery departments), its application under other facts (i.e., with respect to delicatessens and restaurants, among other things) has not been decided by this Board. As a result, if the qualified taxpayer issue is raised in other factual contexts, our analysis in *Save Mart* will certainly serve to guide us, but will not necessarily require a specific outcome, as we will need to examine the activities as alleged in light of R&TC §23649 and *Save Mart*."

Based on the language in *Save Mart and Safeway,* you should continue to review the issue of a taxpayer being a qualified taxpayer in those situations when it is not obvious the taxpayer is a manufacturer. The analysis should give full weight and consideration to the holdings in *Save Mart* and *Safeway* and you should proceed forward according to the facts and circumstances of your case. The taxpayer must show it satisfies all applicable requirements (qualified taxpayer, with qualified costs for qualified property) in order to claim the MIC. When it is obvious a taxpayer is a manufacturer, the amount of time spent documenting that the taxpayer is a qualified taxpayer should be kept to a minimum. In some cases, you will determine the 'qualified taxpayer' test has been met under the *Save Mart and Safeway* decisions, and pursue only the qualified costs and qualified property tests. Regardless of the 'qualified taxpayer' position you may want to propose, your proposal should also fully address the qualified costs and qualified property areas related to any adjustment proposed.

AB 1040 (Ch. 605, Stats 1997) included language stating the legislature's intent to replace the references in §23649 from the SIC Manual to the new North American Industry Classification System (NAICS) Manual. The NAICS is being used for the Principal Business Activity Code Chart found in the California and federal tax booklets. This system replaces the use of the SIC for purposes of business classification. However, until R&TC §23649 is amended, the SIC Manual will continue to be used for purposes of the MIC.

Qualified Property

"Qualified property" refers to new or used IRC §1245(a) tangible personal property or off-the-shelf computer software upon which sales or use tax has been paid. Tangible personal property eligible for the MIC is generally considered to mean any tangible property except land and improvements, such as buildings, other inherently permanent structures, and their structural components. The determination of whether property is considered an inherently permanent structure is made in accordance with the provisions of IRC §1245(a), which describe an "inherently permanent structure" as one, which is affixed permanently and is incapable of being moved without significant damage.

In the appeal of *Bronco Wine Co*, 2002-SBE-006, November 13, 2002, the SBE addressed the 'qualified property' issue regarding "inherently permanent structures." The issue was whether the taxpayer's 215,000 gallon fermentation tanks or the concrete foundations constituted inherently permanent structures or tangible personal property. The SBE held that while the taxpayer's holding tanks qualified as qualified property, the concrete foundations did not. In arriving at its decision, the SBE relied heavily on the six-factors outlined in *Whiteco Industries, Inc. v. Commissioner* (1975) 65 T.C. 664. The SBE concluded that the guiding principle when applying the six-factor *Whiteco* analysis should be whether the property at issue could reasonably be moved and placed back into productive use without damaging the property.

The six factors used in the *Whiteco* analysis are as follows:

- Is the property capable of being moved, and has it in fact been moved?
- Is the property designed or constructed to remain permanently in place?
- Are there circumstances that tend to show the expected or intended length of affixation, i.e., are there circumstances which show that the property may or will have to be moved?
- How substantial a job is removal of the property and how time-consuming is it? Is it "readily removable"?
- How much damage would the property sustain upon its removal?
- What is the manner of affixation of the property to the land?

Each of these factors alone is not decisive in determining whether the property is considered an "inherently permanent structure." Rather, as a whole, the inquiry should be whether the property reasonably can be moved and placed back into productive use without damaging the property.

Because only tangible personal property qualifies for the credit, CCR §23649-5(b)(2) interprets the IRC §1245(a) requirement to mean that only property described in IRC § 1245(a)(3)(A) qualifies for the MIC. One exception to the regulation's general application of the statutory IRC §1245(a) tangible personal property requirement applies to taxpayers engaged in a line of business classified under SIC Code 2911, Petroleum Refining. For this SIC code, qualified property also includes other tangible property defined in IRC §1245(a)(3)(B), such as outdoor permanent industrial structures. This property must be primarily used in petroleum refining for the production of "reformulated gasoline" or "oxygenated gasoline."

Another exception to the general IRC §1245(a) tangible personal property requirement is for special purpose buildings and foundations. Even though they are not IRC §1245(a) tangible personal property, special purpose buildings and foundations may also be considered qualified property, but only for taxpayers that are engaged in manufacturing activities that fall within certain SIC codes (generally related to computer or office equipment; electronic components; biotech or biopharmaceutical activities; space satellites and communications satellites and equipment; or semiconductor equipment). Rules regarding this exception are discussed in R&TC §23649(d)(3) and CCR §23649-5(c).

In the *Appeal of Baxter Healthcare Corporation* (non citable), 2003-SBE, May 28, 2003, the SBE addressed the treatment of "special purpose buildings" and foundations under R&TC §23649(d)(4) in addition to the classification of "structural components" as tangible personal property under the “sole justification” test set forth in Treasury Regulation §1.48-1(e)(2).

In the *Baxter* case, it was found that while certain divisions of the taxpayer apparently are qualified taxpayers for purposes of the MIC, the divisions were not engaged in manufacturing activities qualifying their facilities for treatment as special purpose buildings and foundations under R&TC §23649(d)(4). The taxpayer then attempted to establish the property at issue (HVAC systems) was tangible personal property, and qualified property for the MIC under the “sole justification” test set forth in Treasury Regulation §1.48-1(e)(2).

Although a structural component, HVAC systems may be excluded from that categorization and deemed tangible personal property if the sole justification for installing the HVAC system is to meet essential temperature or humidity requirements.

Similarly, in *A.C. Monk Co., Inc v. United States* (4th Cir. 1982) 686 F.2d 1058, 1066, the court stated the relevant inquiry is “whether the structural components can be reasonably adapted in the present building to more general uses.” If so, the systems are structural components of the building, not tangible personal property, and thus not qualified property.

You should ensure that the taxpayer's determinations are not based solely on the asset description, but upon a thorough understanding of the application, use and potential use of the asset.

Specifically excluded from the definition of qualified property is furniture, equipment used for warehousing or extraction purposes, inventory, or property used in administration, general management or marketing.

To be qualified property, at least 50 percent of the property's use must be in an activity that involves manufacturing, processing, refining, fabricating, recycling, research and development, or pollution control; or the maintenance, repairing, measuring or testing of any other qualified property. The business activity must fall within SIC Codes 2011-3999. Definitions of qualified activities are in CCR §23649-2. Also, examples of when property is treated as being primarily used in a qualified activity are in CCR §23649-5. For guidance on determining whether cement mixers for ready-mixed concrete are qualified property, see Legal Ruling 2001-4.

For taxable years beginning on or after January 1, 1998, qualified property also includes property consisting of computers and computer peripheral equipment (as defined in IRC §168(i)(2)(B)) used primarily by a qualified taxpayer to develop or manufacture prepackaged software or custom software. Qualified property for taxpayers involved in computer businesses described in SIC Codes 7371 - 7373 does not include any IRC §1245(a)(3)(A) tangible personal property other than computers and computer peripheral equipment (e.g., shrink-wrap machines, forklifts, etc.). (R&TC § 23649(d)(2) as amended by AB 2798, Ch. 323, Stats. 1998. See also CCR §23649-5(d)(5).)

Qualified Costs

In general, the term "qualified costs" includes any capitalized costs paid or incurred by a qualified taxpayer for the construction, reconstruction or acquisition of qualified property on or after January 1, 1994. The costs must be properly includable in the taxpayer's depreciable basis of the property. Except for capitalized labor costs, qualified costs are an amount upon which California sales and use tax has been paid (directly or indirectly). For guidance on the use of California State Board of Equalization (SBE) sales and use tax audit results, see FTB Notice 2001-6. Examples of these requirements are in CCR §23649-4(b), (c).

Capitalized labor costs for the construction or modification of qualified property may also qualify for the MIC, provided they meet the definition of “direct” labor costs under the federal uniform capitalization (UNICAP) rules. The UNICAP rules are in IRC §263A and the regulations thereunder. Examples of the capitalized labor cost requirements are in CCR §23649-4(d).

In *Appeal of California Steel Industries, Inc.,* 2003-SBE-001-A, July 9, 2003, the SBE addressed the definition of capitalized labor costs paid to contractors and employees that are qualified costs for purposes of the Manufacturers' Investment Credit (MIC). The SBE held that labor costs paid to independent contractors should include all costs paid or incurred for services rendered in connection with the construction or modification of qualified property, including any overhead and profit attributable to such services. For the union labor costs, amounts include all of the component costs that comprise the total wage rates under master labor agreements. Non-labor costs are all other contract costs including, for example, materials, equipment purchases and/or rentals, small tools and consumables, and all other non-service charges and reimbursable costs, including overhead and profit attributable to such non-labor costs. If, however, a taxpayer can verify payment of sales or use tax on these items, then these non-labor costs may qualify under the general rule of R&TC 23649(b). In addition, the decision affirmed that taxpayers using employee labor for the construction of MIC assets may only claim direct costs of labor as defined in Internal Revenue Code §263A and CCR sections 23649-2(b) and 23649-4(d) as qualified costs for the MIC.

For more guidance on the treatment of capitalized labor, see the SBE's decision in *Appeal of California Steel Industries, Inc.,* 2003-SBE-001-A, July 9, 2003.

A qualified taxpayer who leases qualified property may claim the MIC as long as the lessor paid California sales or use tax when it acquired the property. The lessor may not claim the MIC. The normal "qualified cost" rules do not apply to lessees. Instead, under an operating (or true) lease, the lessee may generally claim the MIC based upon the purchase price amount on which the lessor paid sales or use tax, plus any capitalized labor costs related to the lessor's construction or modification of the property. If the property is later re-leased to another lessee, the second lessee's qualified costs must be reduced by the costs used to compute the prior lessee's MIC. The general requirement that qualified costs must be chargeable to the qualified taxpayer’s capital account does not apply to a lessee’s rental payments under an operating (or true) lease arrangement.

In the case of an operating (or true) lease, the lessor must provide the lessee with a written statement within 45 days after the close of the lessee’s taxable year, containing the amount of the lessor’s qualified costs (i.e., the amount of such cost upon which the lessor has paid California sales or use tax).

If the lease is a finance (or capital) lease for sales and use tax purposes, then the rules applicable to an acquisition will generally apply in calculating the qualified costs of the lessee. These general rules are subject to a few exceptions and refinements depending upon the type of lease and how the transaction is structured. For more information regarding leased property, see R&TC §23649(f) and CCR §23649-6.

The MIC is claimed on FTB Form 3535, Manufacturers’ Investment Credit. The taxpayer is required to complete and attach this form to the return. The FTB Form 3535 contains information such as the description of the property, the qualifying activity, the primary use SIC code, whether or not the property is leased, the date placed in service, the sales or use tax paid, the property cost, any included capitalized direct labor costs, etc.

The first year the MIC may be taken is the qualified taxpayer's first taxable year beginning on or after January 1, 1995. In addition to costs actually paid or incurred during that first taxable year beginning on or after January 1, 1995, qualified costs paid or incurred on or after January 1, 1994, may also be claimed in that first credit year.

For example, assume a taxpayer with a June 30 year-end. The first taxable year this taxpayer can claim the MIC is its year ended June 30, 1996, the first year beginning after January 1, 1995. To determine its credit, the taxpayer may include all qualified costs incurred from January 1, 1994, through June 30, 1996. For qualified taxpayers engaged in those lines of business under SIC Codes 7371 - 7373, substitute “the first taxable year beginning on or after January 1, 1998,” for “January 1, 1994.” Rules with respect to costs incurred pursuant to binding contracts in existence prior to January 1, 1994, are covered in CCR §23649-4(e).

The total cost of property eligible for the credit must be reduced by the amount of sales or use tax paid on the property. However, unlike many credits, the basis of qualified property for which the MIC is claimed is not required to be reduced by the amount of the credit.

There is no annual limit on the MIC. However, the amount of the credit that a taxpayer can use may be limited. The credit may not reduce the minimum franchise tax imposed on corporations and certain other entities. The MIC may not reduce the built-in gains tax or the excess net passive income tax imposed on some S corporations; or the limited liability company (LLC) gross receipts fee. Also, the credit may not reduce alternative minimum tax, but may reduce the “regular” California tax below the tentative minimum tax. If a taxpayer takes a Los Angeles Revitalization Zone Credit (R&TC §23612.6) with respect to the same qualified property, the taxpayer cannot take the MIC for that same item.

Generally, the credit can be carried forward for eight years. Small businesses, defined in R&TC §23649(e)(10), can carry the credit forward for ten years. The length of the credit carryover period for a credit generated by a pass-through entity (S corporation, partnership, LLC taxed as a partnership, etc.) is determined at the entity level. For more information regarding the MIC carryforward provisions, see CCR §23649-9.

If the property upon which the credit is claimed is disposed of within one year or less from the date the property was first placed in service in California, the credit must be recaptured pursuant to R&TC §23649(g). Disposition includes removal of the property from California, use of the property primarily in a nonqualified activity, and transfer or sale of the property to an unrelated party, defined by IRC §267, IRC §318 or IRC §707. For more information regarding the recapture provisions, see CCR §23649-8.

9140 RESEARCH EXPENSES CREDIT

IRC §41 provides for a federal research tax credit equal to 20 percent of the amount by which a taxpayer's qualified research expenditures for a taxable year exceeded its base amount for that year, or for basic research payments. California allows a similar credit against tax for the amounts paid or incurred for research conducted in California. Generally, the credit is allowed in accordance with IRC §41, modified for California by R&TC §23609. There are several other federal and state differences, as well as several law changes that have been made periodically. Therefore, you should be familiar with the California provisions for the year under audit. The research credit for both existing companies and "start-up" companies is claimed on FTB Form 3523.

California's credit for increasing research activities came into existence under R&TC §23609 for corporations in 1988. Taxpayer's may claim the credit for fiscal years beginning in 1987, but only for qualified research expenses paid or incurred on or after January 1, 1988.

For taxable years beginning on or after January 1, 2000, the California credit is 15 percent of the excess of qualified research expenses for the taxable year over the base period research expense amount, plus 24 percent of the basic research payments for corporations. The California research credit rates have changed frequently. See the table below for rates for the year(s) you are auditing.

Corporations may elect to reduce the regular credit to avoid having to make a state adjustment to income for the amount of the credit. According to IRC §280C(c) & R&TC §24440, deductions claimed for research activities must be reduced by the amount of the current year's research credit. However, if the taxpayer makes a timely election, by the due date for filing the return including extensions, to take the reduced credit, then the state adjustment to income is not required. If the taxpayer does not elect the reduced credit, it must add-back the amount of the credit created for the year, regardless of how much of it is actually used to reduce the current year tax liability. Be aware that taxpayers may have a different election for state and federal purposes and they can change the election from year to year, but the election is irrevocable. If the taxpayer does not elect the reduced credit for federal purposes, there should also be a state adjustment to eliminate the IRC §280C(c) add-back. Similar to federal, the election may not be made on an amended return.

For taxable years beginning on or after January 1, 1997, corporations may elect to use the "Alternative Incremental Credit" rather than the regular credit. The alternative incremental credit allows a smaller 3-tiered fixed-base percentage and a reduced 3-tiered credit rate. To use the alternative incremental credit, the taxpayer must make an election for any taxable year beginning on or after January 1, 1997 and cannot change to the regular method unless it receives consent from FTB to revoke the election.

If a material credit is being claimed, you should determine, at the very minimum, whether the research is conducted in California and verify that the computation is mathematically correct. Ensure that California Receipts and Qualified Research Expenditures were used in the computation of the base period percentage. If the IRS is auditing or has audited the same expenses, our audit activity should be limited to verifying that the expenses were incurred in California.

For IY's beginning on or after 12/31/06 the IRS introduced a third method to compute the research credit, commonly referred to as the "Alternative Simplified Credit". In essence, Section 41(c)(5)(A) provided a credit equal to 12 percent of QREs in excess of 50 percent of the average QREs for the three taxable years preceding the taxable year. California has not adopted this method and therefore California taxpayers should not use this method in calculating the California research credit.

California did not conform to the federal fixed-base period computation until January 1, 1993. For years prior to 1993, California used a three-year moving average to compute the base amount. If needed, refer to the prior law and forms for those years.

This table shows the changes in research credit rates:

TAX YEARS BEGINNING	QUALIFIED RESEARCH	BASIC RESEARCH	ALTERNATIVE INCREMENTAL
1987-1996	8%	12%	N/A
1997	11%	24%	1.65%, 2.20%, 2.75%
1998	11%	24%	1.32%, 1.76%, 2.20%
1999	12%	24%	1.32%, 1.76%, 2.20%
2000 and later	15%	24%	1.49%, 1.98%, 2.48%

QUALIFIED RESEARCH EXPENSES

A review of the costs included in the qualified research expense should be considered. The taxpayer must have incurred the costs while conducting research in California for a qualified activity. Qualified research expense equals the sum of in-house research expenses and contract research expenses (IRC § 41(b)(1)). In-house research expenses include compensation, supplies, and amounts paid to another person for the right to use computers in the conduct of qualified research.

IN-HOUSE RESEARCH EXPENSES

COMPENSATION

For purposes of computing this credit, compensation must be directly related to the research activities and paid by the taxpayer (IRC §41(b)(2)). This may include direct supervision, direct support or direct performance of qualified research. An allocation of the purchasing or receiving departments' wages does not qualify because they are indirect costs. Items, which are considered compensation for purposes of determining the credit, include, but are not limited to, salaries, wages and taxable income from non-qualifying stock plans or disqualifying dispositions of incentive stock options (see *Apple Computer v. IRS*, 98 TC 232; and *Sun Microsystems, Inc.,* TC Memo 1995-69, 69 CCH TCM 1884). Deferred compensation and fringe benefits (such as health benefits) are not qualifying expenditures. Information to make the above determinations may be found in employees' W-2 records, job descriptions, duty statements, employee evaluations, etc.

SUPPLIES

Supplies include all tangible property that is consumed directly by the research activity or that goes into the prototype. The supplies must be used in conducting qualified research. Supplies mean any tangible property, <u>other than</u> land or improvements to land, and property of a character subject to the allowance for depreciation (IRC §41(b)(2)). In some cases, the costs attributable to the construction of molds and other special tooling may not be deductible as research and experimental expenditures under IRC §174 because the costs are for the component material and labor associated with the manufacturing of products sold by the taxpayer to its customers.

Examples of supplies that qualify are those used by a laboratory scientist in experimentation, those used by a laboratory assistant in entering research data into a computer, and those used by a machinist in the fabrication of a part for an experimental model. (See Treas. Reg. § 1.41 for more examples.)

Generally, utilities (phone and electricity), small tools, and allocations of the total shipping cost are not qualifying supply expenses. Contract expenses in the cost of supplies are not permissible qualifying supply expenses.

CONTRACT RESEARCH EXPENSES

Contract research means 65 percent of amounts paid to any person (excluding taxpayer's employees) to perform qualified research (IRC §41(b)(3)) (For taxable years beginning on or after January 1, 1997, 75 percent of amounts paid to a qualified research consortium qualify). The outside consultant must perform the research in California. You may review the taxpayer's vendor files and vendor contracts to determine if the expense qualifies.

QUALIFIED RESEARCH DEFINED

Under IRC §41(d)(1), the following four tests must be met for R&D expenditures to be considered qualified research expenses:

- The expenditures must qualify for a deduction under IRC §174,
- The expenditures must have been made to discover information that is technological in nature,
- The purpose of the research is intended to be useful in the development of a new or improved business component of the taxpayer, and
- Substantially all of the activities constitute elements of a process of experimentation that relates to a new or improved function, performance, or reliability or quality.

In reference to the above, be aware that there is no formal "discovery test" or "technological information test" to determine if a taxpayer meets the requirement under IRC §41(d)(1)(B)(i). Research is undertaken for the purpose of discovering information if it is intended to eliminate uncertainty concerning the development or improvement of a business component, and technological in nature if the process of experimentation used to discover such information fundamentally relies on principles of the physical or biological sciences, engineering, or computer science. This applies to all years including tax years beginning before 12/31/03 (effective date of the regulation).

Be mindful not to deny the research credit based on the "discovery test," nor should you refer to the "discovery test" in determining if the taxpayer met the requirements of qualified research under IRC §41. Use the proper test under "technological information" to determine if the taxpayer meets the requirement of IRC §41(d)(1)(B)(i).

A better approach would be to focus on the process of experimentation and review the taxpayer's documentation of the experimentation process. Treasury Regulation section

1.41-4(a)(5)(i) defines the "process of experimentation" in relevant part as "a process designed to evaluate one or more alternatives to achieve a result where the capability or the method of achieving that result, or the appropriate design of that result, is uncertain as of the beginning of the taxpayer's research activities.

INTERNAL-USE SOFTWARE

Software prepared by the taxpayer for its own internal use qualifies for the credit if it is used in an activity that constitutes qualified research or is used in a production process developed through activities constituting qualified research (IRC §41(d)(4)(E)). Other software created for internal use is not eligible for the credit unless it meets the four tests for qualified research (outlined above) plus the following three tests:

- The software must be innovative,
- Its development must involve significant economic risk, and
- It cannot be commercially available for use by the taxpayer.

There are two significant federal court cases concerning qualified activities with regard to internally developed software that you should be aware of:

- *United Stationers, Inc. v. United S*tates (7th Cir. 1998) 163 F.3d 440 - Credit was disallowed based on lack of technological nature and no experimentation process.

- *Norwest Corp. v. Comm'r* (1998) 110 T.C. 454 - Seven of eight internally developed software projects were not considered qualified because the sampled projects involved a "cookbook" approach to development that did not involve technical risk. This case includes a review of the seven tests discussed above.

GROSS RECEIPTS FOR CALIFORNIA PURPOSES

R&TC §23609(h)(3) defines the term gross receipts for purposes of computing the California research credit for taxable years beginning on or after January 1, 1993. When computing the fixed-base percentage and average annual gross receipts for California credit purposes, only California gross receipts are used in the computation. California gross receipts should include receipts, minus returns and allowances, from the sale of real, tangible, or intangible property held for sale to customers in the ordinary course of the taxpayer's trade or business that is delivered or shipped to a purchaser in California. This includes sales to the U.S. government, which are delivered in California. Throwback sales and receipts from services, rents, operating leases and interest are excluded from the computation.

MEMBERS OF A CONTROLLED GROUP:

California conforms to the federal rules for assigning this credit among members of a controlled group (IRC §41(f)). To determine the amount of the credit, all members of the same controlled group of corporations are treated as a single taxpayer.

Treasury Regulation §1.41-6(a) provides a bright line ownership test for groups of organizations under common control. In general, taxpayers that are part of parent/subsidiary groups and brother/sister groups, as defined under Treasury Regulation §1.52-1(b)-(g), will be considered members of the same controlled group for R&D Credit purposes. Treasury Regulation §1.52-1(b) defines "Organizations" as corporations, partnerships, estates & trusts, and sole proprietorships for aggregation purposes.

In the case of a corporation that is part of a parent/subsidiary group, a controlling interest is defined as more than 50 percent of the combined voting power of all classes of stock or more than 50 percent of the total value of shares of all classes of stock.

In the case of a corporation that is part of a brother/sister group, a controlling interest is defined as more than 80 percent of the combined voting power of all classes of stock or more than 80 percent of the total value of shares of all classes of stock held by the same five or fewer persons.

Allocation of the Credit

California conforms to the federal rules for assigning this credit among members of a controlled group (IRC §41(f)). To determine the amount of the credit, all members of the same controlled group of corporations are treated as a single taxpayer.

You must aggregate all components comprising the R&D Credit calculation. Depending on the income year (IY), there could be several options in assigning the credit. However, for IY's after 1/1/2005, the total or "group" R&D Credit is assigned to the members of the controlled group based upon their proportionate share of their stand-alone credit over the total of all computed stand-alone credits for the group. If the "group" credit exceeds the sum of the stand-alone credits, the excess "group" credit is allocated based on each member's qualified research expenses divided by the sum of all members' qualified research expenses. The computed stand-alone credits are only used to determine the proportionate share of group credit to be allocated to a particular member. You compute the stand-alone credit utilizing the best method available (i.e. regular, AIRC, etc.); in other words, you compute to yield the largest credit possible as if you were not part of the controlled group.

For tax years beginning on or after January 1, 1990, a different method of allocating the credit to members of a controlled group was used whereby the credit was allocated to the members based on their proportionate share of research expenses. This method, which has been referred to as the "Expenditure Method," was determined to be incorrect. Proposed Regulation §1.41-8 (issued January 4, 2000) clarified the correct method, and referred to it as the "Incremental Method." Under the "Incremental Method" the group research credit is allocated to each member based on the ratio that the member's increase in its qualified research expenses over its base amount bears to the sum of each member's increase in qualified research expenses over the base amounts.

Taxpayers were allowed to compute the credit using either method for taxable years ending prior to January 4, 2000. For taxable years ending on or after January 4, 2000, taxpayers must follow the incremental method as prescribed in the proposed federal regulation. According to the proposed regulation, this method can also be imposed in prior years if deemed necessary. *

ALTERNATIVE MINIMUM TAX

The credit cannot be used to reduce AMT. However, for taxable years beginning on or after January 1, 1989, R&TC §23036 was revised to allow the research credit to reduce the regular tax below the tentative minimum tax. If the credit is not used in the current year, it may be carried over to subsequent years until it is exhausted.

TERMINATION DATE

R&TC §23609 does not provide a termination date for the California research credit. However, be aware that IRC §41 incorporates a termination date, which changes often. Also, note that the federal credit has a lapse period. No federal credit was allowed for expenses incurred between June 30, 1995 and July 1, 1996. This may explain why the federal credit in those years may be smaller than the California credit.

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9150 California Motion Picture and Television Production Credit

R&TC §17053.85 and R&TC §23685 allow a tax credit based on expenditures incurred for film and television productions. For taxable years beginning on or after January 1, 2011, the credit can be used to offset California income and franchise tax liabilities and/or elect to apply the credit against sales and use tax. Credits applied to the franchise or income tax liability are not refundable. Tax credits issued to an independent film may be assigned or sold to unrelated party. Other qualified taxpayers may assign the credits to an affiliate.

The California Film Commission (CFC) administers California's motion picture credit. The CFC will allocate the tax credits to qualified taxpayers on or after July 1, 2009 and before July 1, 2014. The CFC issues a credit certificate (CFC Schedule M) to the qualified taxpayer once the qualified motion picture is completed and the qualified expenditures are verified. The amount of credit shown on the certificate is the allowed credit.

The CFC provides FTB with a list of qualified taxpayers and the amount of credits allocated to each taxpayer. Contact TRS to obtain information from the list to validate the credit.

The credit is a percentage of qualified expenditures paid or incurred by the qualified taxpayer for the qualified motion picture or television series.

- 20 percent of qualified expenditures attributable to production of a qualified motion picture in California:
    - Feature film ($1 million minimum - $75 million maximum production budget)
    - Movie of the week or miniseries ($500,000 minimum production budget)
    - New television series licensed for original distribution on basic cable ($1 million minimum budget; one-half hour shows and other exclusions apply)
- 25 percent of qualified expenditures attributable a television series or independent film:

- o A television series, without regard to episode length, that filmed all of its prior seasons outside of California and relocated to California
- o An independent film

This credit applies to the following entities:

- Individuals
- Estates and trusts
- C corporations
- S corporations
- General partnerships
- Limited partnerships
- Limited liability partnerships
- Limited liability companies treated as partnerships
- Limited liability companies treated as corporations
- Exempt organizations with unrelated business income

Selling the Credit

A qualified taxpayer may sell a credit, attributable to an independent film, to an unrelated party once they receive the certificate from the CFC. For this purpose, a related party is one that would be treated as a related party under Internal Revenue Code sections 267, 318, or 707. The credit may only be sold once and may not be resold or reassigned. The qualified taxpayer must notify FTB of the sale by filing form FTB 3551, Sale of Credit Attributable to an Independent Film.

Independent Films

R&TC §17053.85(c)(1) and R&TC §23685(c)(3)(A) allow qualified taxpayers to sell a credit attributable to an independent film to an unrelated party.

To qualify as an independent film, the film and producing company must meet the following criteria:

- The film must have a minimum budget of one million dollars ($1,000,000) and a maximum budget of ten million dollars ($10,000,000).
- The film must be produced by a company that is not publicly traded.
- Publicly traded companies cannot directly or indirectly own more than 25 percent of the company producing the film.

Assigning the Credit

Under R&TC Section 23685(c) a qualified taxpayer may elect to assign a credit to an affiliated corporation. An affiliated corporation is one that is owned directly or indirectly, 100 percent of the voting common stock or that is wholly owned by a corporation or an individual owning 100 of the voting stock of the assignor.

The credit can be assigned to one or more affiliates. Qualified taxpayers may elect to split the credit and apply a portion to their income tax liability and a portion to their sales and use tax. Once made, the election is irrevocable.

Tax Forms Development and Distribution Section (TFDD) is currently developing form FTB 3541 to report the assignment and utilization of the credit.

Carryover

In the case where the credit allowed exceeds the "net tax", the unused credit may be carried over for six years. The credit cannot be carried back to any prior year.

Applying Against Sales & Use Tax

Taxpayers may make an irrevocable election with the Board of Equalization (BOE) to apply the credit against qualified sales and use taxes. The credit is refundable and any excess can be carried forward and applied to the sales and use taxes for five years.

Qualified Taxpayer

A qualified taxpayer is a taxpayer who has paid or incurred qualified expenditures and has been issued a credit certificate by the CFC. In the case of pass through entities, determination of a qualified taxpayer is made at the entity level. The credit is not allowed to be used by the passthrough entity, but is passed through to the partners or shareholders. (For example, an S corporation cannot apply 1/3 of the credit toward its tax.)

Qualified Expenditures

Qualified Expenditures are amounts paid or incurred for the purchase or lease of tangible personal property used within California and qualified wages for services performed in California in the production of a qualified motion picture.

Qualified Motion Picture

Qualified motion picture is a motion picture produced for distribution to the general public and is one of the following:

- A feature film with a budget of $1 million (minimum) to $75 million (maximum)
- A television series with a budget of $1 million (minimum) licensed for original distribution on basic cable
- A movie of the week or miniseries with a minimum budget of $500,000
- An independent film with a budget of $1 million (minimum) to $10 million (maximum)
- A television series that relocates to California with no minimum budget and is produced for any media outlet

Auditing the Credit

Since CFC is administering the credit, you do not need to validate the expense. You should confirm the following:

- CFC granted the credit by issuing a credit certificate. ******************* *** ***
- *** ** **
- If credit is sold or assigned and both taxpayers are claiming the credit against their tax, you may deny the credit of either taxpayer, so long as the statue of limitations upon the assessment remains open.

Additional Information

To learn more about applying for and claiming the tax credits, refer to the following websites:

- Franchise Tax Board – Information on claiming the tax credits against franchise or income tax.
- California Film Commission (CFC) - The CFC is administering the tax credit program.
- Fact Sheet: Using the Tax Credits - Developed by the CFC.

- CA Board of Equalization - Information on claiming the tax credits against sales and use tax liabilities.

9160 New Jobs Credit

A new tax credit of up to $3,000 for each additional full-time employee hired is available to small businesses with 20 or less employees beginning January 1, 2009. The credit is prorated on an annual full-time equivalent basis for employees employed less than a full year.

- The credit is not subject to the 50 percent limitation for business credits.
- The total amount of credit available to be claimed by all taxpayers is capped at $400 million.
- The credit must be claimed on a timely filed original return received by the Franchise Tax Board on or before a cut-off date specified by the Franchise Tax Board.
- Taxpayers claiming the credit on an original return received by the Franchise Tax Board after the cut-off date is met will be notified that the credit has been denied.

To Qualify

- An employer will qualify for the credit if:
  - Each qualified full-time hourly employee is paid wages for not less than an average of 35 hours per week.
  - Each qualified full-time employee that is a salaried employee was paid compensation during the year for full-time employment within the meaning of Section 515 of the Labor Code.
  - On the last day of the preceding taxable year, they employed a total of 20 or fewer employees.
  - There is a net increase in qualified full-time employees compared to the number of full-time employees employed in the preceding taxable year. For taxpayers who first commence doing business in California during the taxable year, the number of qualified full-time employees employed in the preceding year would generally be zero, unless certain special rules apply.

Exceptions

- An employer may not claim the credit for those employees who are any of the following:

- Certified as a qualified employee in an enterprise zone or targeted tax area.
- Certified as a qualified disadvantaged individual in a manufacturing enhancement area.
- Certified as a qualified disadvantaged individual or qualified displaced employee in a local agency military base recovery area.
- An employee whose wages are included in calculating any other credit allowed.

The credit is claimed using FTB Form 3527.

NOTE: ((* * *)) = Indicates confidential and/or proprietary information that has been deleted.

Revised: December 2013