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The information provided in the Franchise Tax Board's 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.
12.1 CALIFORNIA/FEDERAL DIFFERENCES

In contrast to federal law that exempts an S-Corporation from federal income tax, California subjects all S-Corporations to the franchise and income tax at a rate of 1.5% or 3.5% for a bank and financial. (R&TC §23802 & §23186) Therefore, the California S-Corporation tax may be offset by credits. (R&TC §23803) The amount of credit allowed against the S-Corporation tax of 1.5% is limited to one-third of the amount allowable under the C-Corporation Tax Law. (R&TC §23803(a)(1))

Additionally, S-Corporations are allowed to carryover a majority of the credits claimed against the 1.5% tax. (R&TC §23803(a)(2)) Finally, unlike federal law, the credit carryovers from C-Corporation years to S-Corporation years are allowed against California’s S-Corporation tax, at one-third of the remaining credit value carried over. (R&TC §23803(a)(2)(C))
12.2 AVAILABLE CREDITS

12.2.1 General
12.2.2 Other State Tax Credit

12.2.1 General

In the case of pass-through entities (partnerships and S Corporations), the determination of whether a taxpayer is qualified for a particular credit is made at the entity level and the credit is then allowed to the entity and passed through to the partners or shareholders.

The California Form 100S Booklet provides a list of available credits. Each credit has certain requirements that must be satisfied in order to be claimed. Therefore, it is important to read the applicable credit statute and accompanying regulations, if any.

The most common credits claimed are:

- The Economic Development Area tax credits,
- The Manufacturer’s Investment credit, and
- The Research & Development credit.

Each of these credits will be discussed in more detail below.

12.2.2 Other State Tax Credit

R&TC §18006 - “Other State Tax Credit” allows an S-Corporation shareholder to treat his/her pro-rata share of net income taxes paid to another state by the S-Corporation as if it had been paid directly by the shareholder. The corporation must have a valid California S election. In addition, the other state must either impose a tax at the S-Corporation level or not recognize the S-Corporation status. Finally, the shareholder must also satisfy the general requirements of either R&TC §18001 or R&TC §18002.
Example A

In 2005, ABC, Inc., a California S-Corporation who apportioned its income within and without of the state, paid net income tax of $3,000 to State A, which does not allow corporations to elect to be treated as an S-Corporations.

During 2005, ABC had three shareholders who each owned 33.3% of ABC’s stock. Pursuant to R&TC §18006, each shareholder can claim his or her pro rata share of the taxes paid to State A (i.e., $1,000) as an “other state tax credit,” assuming that each shareholder can satisfy R&TC §18002.
12.3 EXPIRED CREDITS

FTB Form 3540, Credit Carryover Summary, lists all the credits that have been repealed but which have a carryover provisions. The taxpayer may claim these credits only if carryovers are available from a prior year.
12.4 TAXES THAT MAY NOT BE REDUCED BY CREDITS AND CREDIT CARRYOVERS.

In general, credits and credit carryovers are allowed to offset tax at the S-Corporation level. (R&TC §23803) However, credits and credit carryovers may not reduce the following S-Corporation taxes.

**Minimum Franchise Tax** -- R&TC §23802(c) imposes a minimum franchise tax as provided in R&TC §23153. The tax imposed for any taxable year shall not be less than the minimum franchise tax. (R&TC §23151.1(e))

**QSUB Annual Tax** -- Each member of a QSUB is subject to an annual $800 annual tax, which is paid by the S-Corporation. (R&TC §23800.5(a)(1)(B))

**Built-In-Gains Tax** -- IRC §1374 imposes a tax on built-in gains and allows certain credits to reduce such tax. R&TC §23809(b) modifies IRC §1374 by disallowing credits against the California built-in gains tax.

**Excess Net Passive Income (ENPI) Tax** -- IRC §1375 imposes a tax on excess net passive income and allows certain credits to reduce such tax. R&TC §23811(c) modifies IRC §1375 by disallowing credits against the California ENPI tax.

**Increase in tax imposed for the deferral of installment sale income** -- R&TC §23802(b) subject S-Corporations that qualify under Part 11, Chapter 4.5 of the Revenue and Taxation Code (Tax Treatment of S-Corporations & Their Shareholders) to taxes imposed under Chapter 2 (Corporation Franchise Tax - commencing with R&TC §23101) and Chapter 3 (Corporation Income Tax - commencing with R&TC §23501). Therefore, the increase in tax required by either R&TC §24667(e)(1) or (f)(2) is not considered a “tax” and cannot be reduced by the credits.

Under Chapter 1 (General Provisions & Definitions for the Corporation Tax Law) R&TC §23036(a)(2) defines the term “tax” not to include any amount imposed under paragraph (1) of subdivision (e) of R&TC §24667, Reporting of Income from Installments Sales, or paragraph (2) of subdivision (f) of R&TC §24667.
Installment of LIFO recapture tax -- IRC §1363(d)(1) requires a C-Corporation that inventoried goods under the LIFO inventory method during its last taxable year before electing to be treated as an S-Corporation, to included into the income of the last C-Corporation tax year the LIFO recapture amount. Any resulting increase in tax is payable in four equal installments over four tax years. The first installment is payable with the final return as a C-Corporation (IRC § 1363(d)(2)) and the remaining three payments are made with the S-Corporation Return.
12.5 CREDIT RECAPTURES

Tax credits often have provisions requiring that an amount of the credit taken by a taxpayer in an earlier year be added back to the taxpayer's tax (or "recaptured") in a subsequent year if the taxpayer does not meet specified standards of performance. These recapture provisions are often tied to the creation or retention of a specific number of jobs. Another common recapture provision is to require use of the property for a specified period or in a specified geographic location.

The following are identified credits containing recapture provisions:

- Employer Child Care Program/Contribution Credit:
  
  FTB Form 3501: Employer Child Care Program/ Contribution Credit
  R&TC §17052.17(j)(2) and R&TC §23617(j)(2)

- Hiring Credit (Enterprise Zone):
  
  FTB Form 3805Z: Hiring Credit - Enterprise Zone
  R&TC §17053.74(e)(1)  R&TC §23622.7(e)(1) a

- Hiring Credit & Sales or Use Tax Credit (LAMBRA):
  
  FTB Form 3807: Hiring Credit & Sales or Use Tax Credit - Local Area Military Base Recovery Area
  R&TC §17053.46(e) R&TC §23646(e).

- Hiring Credit (MEA):
  
  FTB Form 3808: Hiring Credit - Manufacturing Enhancement Area
  R&TC §17053.47(d) and R&TC §23622.8(d).

- Hiring Credit (TTA):
  
  FTB Form 3809: Hiring Credit - Targeted Tax Area
  R&TC §17053.34(f) and R&TC §23634(f).
Manufacturers’ Investment Credit:

FTB Form 3535: Manufacturers’ Investment Credit
R&TC §17053.49(g) and R&TC §23649(g) - repealed effective January 1, 2004

Example A

ABC, Inc. utilizes the Employer Child Care Program credit (R&TC §23617). The childcare center is disposed of or stops operating within 60 months after completion. The portion of credit claimed that represents the remaining portion of the 60-month period must be recaptured. (R&TC §23617(j)(2)) ABC must add the recapture amount to its tax liability in the taxable year of disposition or nonuse.
12.6 CREDIT CARRYOVERS FROM C-CORPORATION YEARS

In general, the IRC does not permit credit carryovers between C-Corporation and S-Corporation years. (IRC §1371(b)(1)) However, for purposes of determining the California S-Corporation franchise or income tax, California modifies this general rule to allow credit carryovers from C-Corporation years, subject to the following provisions. (R&TC §23803(a)(1))

Credit carryovers from C-Corporation years are reduced to one-third for the first taxable year, but not the subsequent years. (R&TC §23803(a)(1)(C)) The remaining two-thirds credit is disregarded. (R&TC §23803(a)(2)(B)) Additionally, no portion of the C-Corporation tax year credits are allowed to pass through to the shareholders. (R&TC §23803(a)(2)(E))

Example A

ABC, Inc. made a valid California S-Corporation election in 2003.

In 2002, ABC claimed a Research and Development Credit of $70,000 as allowed under R&TC §23609. Its tax liability in 2002 was $10,800. ABC used $10,000 of the credit in 2002 to reduce its tax liability, but not below the minimum franchise tax. The remaining $60,000 was carried over to the next tax year.

In 2003, ABC reduced the credit carryover to $20,000 ($60,000 x 1/3) upon conversion from a C-Corporation to an S-Corporation. In 2003, ABC’s tax liability was $15,800. ABC used $15,000 of the remaining $20,000 to reduce its tax liability, but not below the minimum franchise tax. ABC may carry forward the remaining $5,000 credit to 2004. The credit generated and carried over from the C-Corporation years cannot be passed through to the shareholders. Thus, ABC’s shareholders are not entitled to any portion of the $20,000 Research and Development Credit.
12.7 CREDITS GENERATED IN S-CORPORATION YEARS

For California purposes, an S-Corporation and its shareholders are subject to both Corporation Tax Law (CTL) and Personal Income Tax Law (PITL). Credits generated at the S-Corporation level may require application of the PITL for purposes of computing the allowable credit at the shareholder level. (IRC §§1363 and 1366; R&TC §23800, R&TC §23802, and R&TC §23803.)

If the credit is allowed only under the CTL, one-third of the credit may be utilized to offset the franchise or income tax at the S-Corporation level. The remaining two-thirds is disregarded and may not be carried over. No part of the credit may be passed through to the shareholders. (R&TC §23803(a))

**Note:** When calculating the credit, apply the CTL to determine whether the S-Corporation is entitled to a particular credit, then reduce the allowable credit by two-thirds as provided in R&TC §23803(a)(1). (See R&TC §23802.) S-Corporation may utilize only one-third of a credit.

**Example A**

In 2003, ABC, Inc., a California S-Corporation, computed its allowable Manufacturers' Investment Credit of $86,250 (R&TC §23649 - repealed effective January 1, 2004). ABC, Inc. may utilize only $28,750 ($86,250 x 1/3) to offset its liability. The remaining $57,500 ($86,250 - $28,750) is disregarded.

ABC’s tax liability in tax year 2003 was $5,800. It recognized $5,000 of the credit, which reduced its tax liability, but not below the minimum franchise tax. The remaining $23,750 ($28,750 - $5,000) is carried over into the 2004 tax year.

If the credit is only allowed under the PITL, the full credit may be passed through to the S-Corporation’s shareholders, and the S-Corporation may not use any part of the credit. (See R&TC §23803(a)(2)(F).)
**Note:** When calculating the PIT credit amount, apply the PITL (if different from the CTL) to determine the allowable credit. This amount passes through to the shareholders.

If a particular credit is allowed under both the CTL and PITL, one-third of the credit as determined under CTL may be utilized by the S-Corporation to offset the tax on net income at the S-Corporation level. (R&TC §23803(a)(1)) The remaining two-thirds must be disregarded and may not be used as a carryover. (R&TC §23803(a)(2)(A)) However, the full credit amount as calculated under the PITL may be passed through to the shareholders. (R&TC §23803(a)(2)(F))

**Note:** Separate calculations are required at the corporate level and shareholder levels when a credit is allowed under both the CTL and the PITL. Calculate the credit using the CTL to determine the allowable credit at the S-Corporation level and calculate the credit using the PITL to determine the allowable credit at the shareholder level.

### Example B

ABC, Inc. has a valid Federal and California S-Corporation election for taxable year 2003. Two individuals each own 50% of ABC.

ABC incurred $600,000 in costs that qualify for the Manufacturers’ Investment Credit (MIC) under R&TC §23649 - repealed effective January 1, 2004, which resulted in an allowable credit of $36,000 ($600,000 x 6%).

The allowable credit at the S-Corporation level is $36,000, which is limited to 1/3 of the amount otherwise allowable. ABC may use $12,000 ($36,000 x 1/3) to offset the 1.5% tax in taxable year 2003.

R&TC §17053.49 is identical to R&TC §23649. In that each shareholder is entitled to a credit of $18,000 (his/her pro-rata share of the $36,000).
12.8 CREDITS CARRIED OVER TO C-CORPORATION YEARS

If a corporation generates a credit during an S-Corporation year and later converts to a C-Corporation through termination of its S-Corporation election, any unused credit cannot be used to reduce C-Corporation taxes after conversion. IRC §1371(b) prohibits carry-forwards and carry-backs between C-Corporation and S-Corporation years. California made one modification to this provision by allowing unused C-Corporation credits to be carried over, reduced to 1/3, and used against tax assessed at the S-Corporation level. (R&TC §23803(a)(1)(C)) The R&TC has made no modifications to allow credits generated at the S-Corporation level to be carried over and used by a C-Corporation.

Example A

ABC, Inc., a California S-Corporation, generated a Research and Development (R&D) credit of $300,000 in taxable year 2003. The credit allowed to reduce the franchise tax imposed against ABC was $100,000 ($300,000 \times 1/3). ABC, Inc. reported a taxable loss in this year; therefore, ABC, Inc. could not utilize any portion of the credit.

Effective January 1, 2004, ABC terminated its Federal and California S-Corporation election by revocation. ABC, Inc. may not carryover the unused $100,000 of R&D credits to the C-Corporation years. There are no provisions contained in the Federal or California law that allow carryovers between C-Corporation and S-Corporation years. If ABC makes a valid Federal and California S-Corporation election effective January 1, 2009 (five years from the date of termination), the credit can be used at this time. In other words, the credit is not lost upon conversion from an S-Corporation to C-Corporation, but rather it is suspended until the taxpayer becomes an S-Corporation again. (IRC §1371(b) & R&TC §23806)

Note: The R&D credit of $300,000 generated in 2003 is passed through to the shareholders. The shareholders are entitled to recognize the credit after conversion from a S-Corporation to a C-Corporation but are still subject to the credit limitations under IRC §41(g).
12.9 REDUCING EXPENSES BY THE AMOUNT OF CREDIT TAKEN

In general, certain credits require that an expense be reduced by the amount of credit generated. However, other credits may require expense reduction only up to the amount of credit recognized currently. For S-Corporations, expense reductions will be different for the amount reduced at the S-Corporation level and at the shareholder level.

Example A

ABC, Inc., generated a credit of $90,000 for wages paid to employees in an Enterprise Zone in tax year 2004.

Per R&TC §23622.7(h), “any deduction otherwise allowed under this part for the wages or salaries paid or incurred by the taxpayer upon which the credit is based shall be reduced by the amount of credit, prior to any reduction required by subdivision (i) or (j) [credit in excess of tax for the income year and credit carryovers from prior years].”

Per R&TC §23803(a)(1), “The amount of any credit to be claimed [by an S-Corporation] shall be limited to one-third of the amount otherwise allowable.”

Which credit amount is used for expense reduction regarding the corporation: (1) the full amount of the credit $90,000, or (2) The one-third amount otherwise allowable, $30,000 ($90,000 x 1/3)?

The reduction amount is $30,000, the one-third amount otherwise allowable. This reduction is required regardless of whether the corporation is able to utilize the entire credit in 2004.

ABC, Inc. would report the following on their return:
• State Adjustment, Other Additions (face of Form 100S): + $30,000. [Wage or salary expense reduction by the amount of credit]
• Credit of $30,000

On the K-1 to the Shareholders:

The Schedule K, line 1, ordinary income (loss) from trade or business
activities, state adjustments column: + $90,000. [The full amount of the shareholders’ credit]

Schedule K, credit for wages paid to employees in an Enterprise Zone: $90,000.

As you can see, the S-Corporation's add-back for wage deductions is equal to its credit of $30,000 while the shareholders' add-back for wage deductions equal to their credit of $90,000.

**Note:** When tracing the flow of information on the return, the sum of state adjustments applicable to nonseparately stated items contained on the face of Form 100S should not agree with the amount on Schedule K, line 1 - state adjustments if the taxpayer prepared the form properly.
12.10 ECONOMIC DEVELOPMENT AREAS TAX CREDITS

California currently has four types of Economic Development Areas (EDAs) that have related tax incentives (e.g., tax credit, net operating losses, business expense deductions). These areas are:

- 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 may qualify for special state 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)** - The LARZ incentives applied to taxable years beginning on or after January 1, 1992, and before January 1, 1998.
- **Program Areas** - 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,
- **Enterprise Zone (EZ) – City of Lynwood** -- The City of Lynwood was formerly a part of the Los Angeles Mid-Alameda Corridor EZ. However, when the zones designation was extended on October 15, 1996 the City of Lynwood was included and therefore expired on October 14, 2001.

A number of the EZs whose expiration dates were due to expire on October 14, 2001 received a five-year extension. The new expiration date was October 14, 2006. The following are EZ that expired during 2006:

<table>
<thead>
<tr>
<th>Zone Name</th>
<th>Designation Date</th>
<th>Expiration Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bakersfield/Kern (SE Bakersfield)</td>
<td>10/15/86</td>
<td>10/14/06</td>
</tr>
<tr>
<td>Calexico</td>
<td>10/15/86</td>
<td>10/14/06</td>
</tr>
</tbody>
</table>

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The following is a list of EZ who have received Conditional Designation:

<table>
<thead>
<tr>
<th>Zone Name</th>
<th>Coverage Area</th>
</tr>
</thead>
<tbody>
<tr>
<td>Arvin</td>
<td>City of Arvin</td>
</tr>
<tr>
<td>Delano</td>
<td>City of Delano</td>
</tr>
<tr>
<td>Fresno-City</td>
<td>City of Fresno</td>
</tr>
<tr>
<td>Fresno-County</td>
<td>Cities of Fowler, Firebaugh, Kerman, Mendota, Orange Cove, Parlier, San Joaquin, Sanger, Selma, County of Fresno</td>
</tr>
<tr>
<td>Merced</td>
<td>Cities of Los Banos, Atwater, Dos Palos, Gustine, Livingston, Merced, County of Merced</td>
</tr>
<tr>
<td>North Sacramento</td>
<td>City and County of Sacramento</td>
</tr>
<tr>
<td>Location</td>
<td>Description</td>
</tr>
<tr>
<td>--------------------------</td>
<td>-------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Yuba Sutter</td>
<td>Cities of Marysville, Yuba City, Wheatland, Live Oak, Counties of Yuba and Sutter</td>
</tr>
<tr>
<td>Calexico</td>
<td>City of Calexico, County of Imperial</td>
</tr>
<tr>
<td>San Bernardino</td>
<td>Cities of San Bernardino and Colton, County of San Bernardino, Inland Valley Development Agency</td>
</tr>
<tr>
<td>Coachella</td>
<td>Cities of Coachella and Indio, County of Riverside</td>
</tr>
<tr>
<td>Los Angeles-Central/Hollywood</td>
<td>City of Los Angeles – Central City and Hollywood</td>
</tr>
<tr>
<td>Compton</td>
<td>City of Compton</td>
</tr>
<tr>
<td>Santa Clarita</td>
<td>City of Santa Clarita</td>
</tr>
<tr>
<td>Long Beach</td>
<td>City of Long Beach</td>
</tr>
<tr>
<td>Pasadena</td>
<td>City of Pasadena</td>
</tr>
<tr>
<td>Southgate/Lynwood</td>
<td>Cities of Southgate and Lynwood</td>
</tr>
<tr>
<td>San Diego</td>
<td>Cities of San Diego, Chula Vista, National City</td>
</tr>
<tr>
<td>Richmond</td>
<td>City of Richmond</td>
</tr>
<tr>
<td>San Francisco</td>
<td>City and County of San Francisco</td>
</tr>
<tr>
<td>San Jose</td>
<td>City of San Jose</td>
</tr>
<tr>
<td>Shasta</td>
<td>Cities of Redding, Anderson, Shasta Lake, County of Shasta</td>
</tr>
<tr>
<td>Eureka</td>
<td>City of Eureka, County of Humboldt</td>
</tr>
<tr>
<td>Oroville</td>
<td>City of Oroville</td>
</tr>
</tbody>
</table>

The Economic Development Areas Manual ("EDAM") discusses the statutory provisions for each of the EDA tax incentives and how each incentive is applied to S-Corporations and their shareholders. This manual will not discuss the specifics with regard to the EDAs Tax Credits, other than to provide a chart indicating the credits available to S-Corporations and where they can be found in the EDAM. For more information on Economic Development Areas, go to the EDAM.
12.11 MANUFACTURERS’ INVESTMENT CREDIT

12.11.1 General Information

On June 17, 2003 the California Legislative Counsel issued a written opinion stating that the MIC statute has been repealed by its own terms and ceases to be operative as of January 1, 2004 due to a reduction in the manufacturing sector jobs.

The Manufacturers’ Investment Credit, or MIC, was available to qualified taxpayers engaged in certain manufacturing activities. The credit was generated in the taxable year in which the qualified property is placed in service in California before January 1, 2004 and was equal to 6% of qualified costs paid or incurred for acquiring, constructing, or reconstructing the qualified property. (See R&TC §23649 - repealed effective January 1, 2004) The MIC regulations provide the definition of the term “placed in service” for purposes of the MIC and should be consulted by taxpayers with issues in this area. (Cal. Code Regs., tit. 18, §§ 17053.49-2, sub. (i), & 23649-2, sub. (i).)

The credit cannot be claimed for any property for which a California sales or use tax exemption (R&TC §6377) or refund (R&TC §6902.2) has been claimed (CCR §23649-11(c) and (d)).

The MIC cannot reduce the S-Corporation’s:
- Minimum Franchise Tax,
- Built-in Gains Tax,
- Excess Net Passive Income Tax, or
- Alternative Minimum Tax. (See R&TC §§23036(a) and 23649(a)(1).)
However, these credits can reduce the regular tax below tentative minimum tax. (R&TC §23036(d)(1))

The terms qualified taxpayer, qualified costs, and qualified property are defined uniquely for California’s MIC. Each of the MIC qualification requirements is briefly discussed in the following sections. Sections on Leased Property, Carryovers, S-Corporations and Credit Recapture for S-Corporations and their shareholders are also included.

For more information on the MIC, see R&TC §17053.49 and R&TC §23649 – (repealed effective January 1, 2004) and the accompanying regulations. See also the MIC web page.

12.11.2 Qualified Taxpayer

Qualified taxpayer means any taxpayer engaged in those lines of business described in Division D, Manufacturing, of the Standard Industrial Classification (SIC) Manual, published by the United States Office of Management and Budget, 1987 edition. Generally, this means that a taxpayer must have, as part of its overall “enterprise”, at least one establishment that is properly classified under a SIC Code in Division D of the SIC Manual. Division D includes SIC Code number 2011- SIC Code number 3999, inclusive. For taxable years beginning on or after January 1, 1998, a qualified taxpayer also includes any taxpayer engaged in a line of business described under SIC Code 7371, SIC Code 7372, and SIC Code 7373, inclusive. (R&TC §23649(c)(1) - repealed effective January 1, 2004 ; CCR §23649-3 or CCR §23649-3(b))

The determination of whether a taxpayer is engaged in a line of business described in Division D or SIC Code 7371, SIC Code 7372, and SIC Code 7373 of the SIC Manual is made by reference to the classification of business activity rules contained in the introduction and description of industries in the SIC Manual (CCR §23649-3(b))
NOTE: The auditor should keep in mind that we should not disqualify the taxpayer based on the SIC only. The development of the case should include the verification of qualified property and qualified costs.

12.11.3 Qualified Costs

To qualify for the credit, costs must meet all of the following requirements (R&TC §23649(b)(1) - repealed effective January 1, 2004):

- The costs must be paid or incurred on or after January 1, 1994, and prior to January 1, 2004, for the construction, reconstruction, or acquisition of qualified property.

- Costs must be amounts upon which California sales or use tax has been paid, except for capitalized labor, and

- Costs must be amounts that are properly chargeable to the capital account of the qualified taxpayer, except for lease payments under operating or true leases.

In order for costs to qualify for the MIC, California sales or use tax must be paid, on the qualified property acquired. The sales or use tax may be paid either directly or indirectly by the qualified taxpayer, as a separately stated contract amount or as established from the books and records of the qualified taxpayer. (R&TC §23649(b)(1)(B) - repealed effective January 1, 2004; CCR §23649-4(b))

Where the Board of Equalization (BOE) has examined a taxpayer's fixed assets in connection with a sales and use tax audit for the same year in which a MIC is claimed, and the taxpayer can establish that the assets upon which the MIC is claimed are included within the scope of the BOE audit, the department will accept the BOE audit determinations for the payment of both sales and use tax. FTB Notice 2001-6.

Example A

T, a qualified taxpayer, enters into a “fixed-price, turn-key” contract with R,
The terms of which requires T to pay R a total of $540,000 upon delivery and installation of two compressors in T’s manufacturing facility in Auburn, California.

Instead of delivering a resale certificate to W, a wholesale distributor of the air compressors, R pays $40,000 ($500,000 x 8%) in California sales tax to W on its purchase of the compressors.

Under R’s contract with T, the $40,000 California sales tax paid by R is a separately stated item. Since the sales tax was separately stated in M’s contract with R and paid by R on behalf of T, T is treated as having satisfied the sales tax payment requirement.

However, because $40,000 of the total contract price represents the sales tax paid indirectly by T, the amount of T’s qualified cost is $500,000. (CCR §23649-4(a).)

Qualified costs must be properly chargeable to the capital account (i.e., capitalized, not currently expensed) of the qualified taxpayer in order to qualify for the MIC. (R&TC §23649(b)(1)(C) - repealed effective January 1, 2004; CCR §23649-4(a))

To meet the capitalization requirement, costs must be included in the tax basis for computing depreciation under the taxpayer's method of tax accounting. Costs not included in the depreciable basis for tax purposes are not eligible for the MIC.

For example, amounts currently expensed under IRC §179 and similar provisions such as the LARZ business expense deduction and the EZ business expense deductions are not qualified costs for the MIC. Similarly, qualified costs for the MIC are limited to the reduced basis amounts resulting from IRC §§1031 and 1033 transactions. (CCR §23649-4(c))

Capitalized labor costs for the construction or modification of qualified property may also qualify for the MIC, provided the labor costs meet the definition of “direct” costs of labor under the Federal uniform capitalization (UNICAP) rules contained in IRC §263A. Such costs are not subject to the sales or use tax payment requirement except to the extent the measure of
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capitalized labor costs include items subject to sales or use tax. (R&TC §§23649(b)(1)(B) and 23649(d)(3) - repealed effective January 1, 2004; CCR §§23649-2(b) and 23649-4(d))

Direct costs of labor include wages, overtime pay, vacation, payroll taxes and sick pay, but do not include training costs, officer’s compensation, pension and other related costs, and employee benefit expenses. (CCR §23649-2(b)) See FTB Legal Ruling 1998-1, Manufacturers’ Investment Credit-Capitalized Costs of Labor for Engineering and Design and Legal Ruling 2000-1, Manufacturers’ Investment Credit-Capitalized Costs Under Third-Party Contracts for more information on MIC capitalized labor costs.

12.11.4 Qualified Property

Qualified property includes new or used tangible personal property as defined in IRC §1245(a) (R&TC §23649(d)(1) - repealed effective January 1, 2004; CCR §23649-5(a)). For taxable years beginning on or after January 1, 1998, qualified property also includes computer and computer peripheral equipment (as defined in IRC §168(i)(2)(B)) that is used in operating establishments classified under SIC Code 7371, SIC Code 7372, and SIC Code 7373. (R&TC §23649(d)(2) - repealed effective January 1, 2004)

Computer and computer peripheral equipment must be used to primarily develop or manufacture prepackaged software or custom software prepared to the special order of the purchaser who uses the program to produce and sell or license copies of the program as prepackaged software. Qualified property for taxpayers involved in computer businesses described in SIC Code 7371, SIC Code 7372, and SIC Code 7373 do not include any IRC §1245(a)(3)(A) tangible personal property other than computers and computer peripheral equipment. (R&TC §23649(d)(2) - repealed effective January 1, 2004)

Tangible personal property eligible for the MIC is generally considered to mean any tangible property except land and improvements thereto, such as buildings, other inherently permanent structures and their structural components. The classification of property as tangible property or personal property for local property tax purposes does not determine its classification as tangible personal property for MIC purposes. (CCR §23649-5(b)(1))

department is utilizing the factors contained in Whiteco Industries, Inc. v. C.I. R., (1975) 65 T.C. 664, to determine whether large items of property are tangible personal property or inherently permanent structures.

The tangible personal property must be used in both an activity that is described in Division D of the SIC Manual and used primarily in any of the following qualified activities. (R&TC §23649(d)(1)(A-E) - repealed effective January 1, 2004):

- Manufacturing, processing, refining, fabricating, or recycling;
- Research and development;
- Maintaining, repairing, testing or measuring other qualified property;
- Pollution controls meeting or exceeding established state or local government agency standards; or
- Recycling.

There are exceptions to the MIC's tangible personal property rule for:

- **Off-The-Shelf Software** - Off-The-Shelf software is pre-packaged software purchased and applied without modification. A separate MIC section was inserted for this product because at the time it was not clear whether this type of software constituted "tangible personal property" under the general MIC provision in R&TC §23649(d)(1) - repealed effective January 1, 2004. Because of the placement of this provision in R&TC §23649(d)(5) - repealed effective January 1, 2004, no capitalized labor costs are allowed in connection with this property (capitalized labor is only allowed in connection with property described in R&TC §23649(d)(1) and (d)(2) - repealed effective January 1, 2004).

In addition, the acquisition of custom software (made to the specific specifications of the end user) is generally not subject to sales tax under California sales tax law (it is treated as a service as opposed to goods). Accordingly, costs for custom software are generally not qualified costs for the MIC.

- **Special Purpose Buildings and Foundations** - Special purpose buildings and foundations may also be considered "qualified property",

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but only for taxpayers engaged in manufacturing activities within the following specified SIC Codes:

- SIC Code 3571, SIC Code 3572, SIC Code 3573, SIC Code 3574, SIC Code 3575, SIC Code 3576, SIC Code 3577, SIC Code 3578, and SIC Code 3579 (Computer and Office Equipment);
- SIC Code 3671, SIC Code 3672, SIC Code 3673, SIC Code 3674, SIC Code 3675, SIC Code 3676, SIC Code 3677, SIC Code 3678, and SIC Code 3679 (Electronic Components and Accessories);
- SIC Code 8731 (Commercial Physical and Biological Research);
- SIC Code 2833, SIC Code 2834, SIC Code 2835, and SIC Code 2836 (Biopharmaceutical Activity, Drugs);
- SIC Code 3761, SIC Code 3762, SIC Code 3763, SIC Code 3764, SIC Code 3765, SIC Code 3766, SIC Code 3767, SIC Code 3768, and SIC Code 3769 (Space vehicles and parts);
- SIC Code 3663 and SIC Code 3812 (Space Satellites and Communications Satellites and Equipment), but only with respect to “qualified property” that is placed in service on or after January 1, 1996; and
- SIC Code 3559 (Semiconductor Equipment) but only with respect to “qualified property” that is placed in service on or after January 1, 1997. (R&TC §23649(d)(4)- repealed effective January 1, 2004; CCR §23649-5(c))

A special purpose building and foundation is a structure that has been specifically designed for exclusive use in a specific manufacturing process. (R&TC §23649(d)(4)(A) - repealed effective January 1, 2004; CCR §23649-5(c)(1)) One example is a "clean room," where stringent environmental conditions are required due to the nature of the item being manufactured, such as semiconductor wafer fabrication. (CCR §23649-5(c)(4)) The value of any capitalized direct labor costs that are directly allocable to the construction or modification of special purpose buildings and foundations...
may also qualify for the MIC. (R&TC §23649(d)(4)(B) - repealed effective January 1, 2004; CCR §23649-4(d))

For more information on special purpose buildings and foundations see R&TC §23649(d)(4) - repealed effective January 1, 2004 and CCR §23649-5(c).

- **Other tangible property** - For qualified taxpayers engaged in refining activities properly classified in SIC Code 2911, "qualified property" also includes “other tangible property” that is defined in IRC §1245(a)(3)(B) and that satisfies each of the following requirements:
  
  - Used in that line of business properly classified in SIC Code 2911;
  - Used primarily in refining; and
  - Used to produce "reformulated gasoline" or "oxygenated gasoline."

For more information on this specific requirement see CCR §23649-5(f).

**12.11.5 Non-Qualified Property**

The following types of property are specifically excluded from the definition of "qualified property" for purposes of the MIC (R&TC §23649(d)(6) - repealed effective January 1, 2004; CCR §23649-5(d)):

- Furniture;
- Facilities used for warehousing purposes, after completion of the manufacturing process;
- Inventory;
- Equipment used in the extraction process (e.g. oil, gas, water, etc. extraction from the earth);
- Equipment used to store finished products; and
- Tangible personal property used in administration, general management, or marketing.
- Vehicles for which a low-emission vehicle credit (R&TC §17052.11 - repealed effective January 1, 1996 and §23603 - repealed effective January 1, 1996) is claimed.
12.11.6 Leased Property

Property acquired pursuant to either an operating lease (true lease) or a finance lease (capital lease) may also qualify for the MIC, provided that the property meets all other qualification requirements. The credit amount allowed to a lessee is generally equal to the purchase price on which the lessor has paid California Sales or Use Tax, plus qualified capitalized labor costs. The MIC statute and regulations discuss specific criteria that must be met in order for leased property to be eligible for the credit. (R&TC §23649(f) - repealed effective January 1, 1996; CCR §23649-6)

First, the lessor is never entitled to claim the MIC with respect to any item of qualified property it leases to another party, regardless of whether the lessor is a qualified taxpayer. (R&TC §23649(f)(1) - repealed effective January 1, 2004) Only the lessee is entitled to claim the MIC on the leased asset. The lessee must be a qualified taxpayer, and the leased property must be qualified property used in a qualified activity.

Second, in order for leased property to be eligible for the MIC, California sales or use tax must be paid on the construction, reconstruction or acquisition of leased property. In an operating or “true lease” arrangement, the lessor must elect to pay the sales tax up front when the lessor acquires the property. (R&TC §23649(f)(3)(iii) - repealed effective January 1, 2004; CCR §23649-6(b)(2)(C)) Under a finance lease, either the lessor or lessee must elect to pay the California sales or use tax based on the lessee’s acquisition price, excluding any capitalized labor costs, of the leased property at the time of the purchase. (R&TC §23649(f)(4)(C) - repealed effective January 1, 2004; CCR §23649-6(c)(2)(C))

Example A

P, a financing institution, leases two drill presses to Q, a qualified taxpayer. The total cost under the terms of the lease is $500,000 (P’s acquisition cost), plus $35,000 in California sales tax and a finance charge equal to the market rate of interest for loans for a similar period. Assume Q will be using the drill presses in its manufacturing facility in Los Angeles. If either P (the lessor) or Q (the lessee) remits the $35,000 sales tax to the California State Board of Equalization at the inception of the lease, then Q will be entitled to claim the MIC on the acquisition cost of $500,000.
If the lessor previously leased the property to another lessee under a previous operating lease and the MIC was claimed, and the property is re-released to another qualified taxpayer, then the qualified cost of property must be reduced by the amount of the original cost used in computing the MIC. However, this reduction is not required to the extent the predecessor lessee was required to recapture the MIC. (R&TC §23649(f)(3)(B)(i) and (ii) - repealed effective January 1, 2004; CCR §23649-6(b)(4)(C)) Also, if a lessor acquires qualified property that was previously leased from another lessor under an operating lease, the original cost to the new lessor for MIC purposes is reduced by the amount of the qualified cost used in computing the MIC by the predecessor lessee. (R&TC §23649(f)(3)(B)(iii) - repealed effective January 1, 2004; CCR §23649-6(b)(4)(D)) This generally results in both cases in the reduction of qualified costs to zero for purposes of computing the MIC unless the lessor pays California sales or use tax on the acquisition.

Note that, under an operating or true lease, the lessor generally does not pay sales or use tax upon acquisition of the leased property and instead collects use tax payments from the lessee, measured by the lessee’s rental payment stream to the lessor. (CCR §23649-6(c)(2)(C)) In order to claim the MIC the parties must alter normal business practices and the lessor must pay the sales or use tax up front upon acquisition of the property.

Example B

R, a financing company, leases qualified property to S. R does not pay California sales or use tax at the time of purchase. R delivered a resale certificate to S. R instead collects use tax from S over the lease term as part of the monthly lease agreement. According to California sales and use tax law, this transaction would be treated as a finance lease.

However, in this case, the property would not qualify for the MIC because neither R (the lessor) nor S (the lessee) paid California sales or use tax at the time the property was acquired (up-front).
Third, 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. (CCR §23649-6(b)(2)(E) - repealed effective January 1, 2004) Thus, a lessee may take a current deduction of rent expense and still claim the MIC. However, in the case of a finance or capital lease, the qualified costs must be chargeable to the capital account. (CCR §23649-6(c)(2)(E))

Fourth, 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 income year, containing the amount of the lessor’s qualified cost. That is, the amount of such cost upon which the lessor has paid California sales or use tax. In addition, the lessor must provide the amount eligible for the credit, which would include qualified capitalized labor costs, if any. (R&TC §23649(f)(5)(A) - repealed effective January 1, 2004; CCR §23649-6(b)(6))

For more information on the special rules for leased property, see R&TC §23649(f) - repealed effective January 1, 2004 and CCR §23649-6.

12.11.7 Credit Carryover

There is no limitation on the amount of credit that a taxpayer may be entitled in any taxable year. However, the amount of the credit that a taxpayer can use may be limited. Any unused credit may be carried forward for a maximum of eight (8) years. (R&TC §23649(h)(1) - repealed effective January 1, 2004) If the qualified taxpayer meets the definition of a “small business” as of the last day of the taxable year, in which the credit is first allowed, then the carryover period is ten (10) years. (R&TC §23649(h)(2) - repealed effective January 1, 2004) The credit cannot be carried back and applied against a prior year’s tax.

The length of credit carryover period generated by an S-Corporation is determined at the pass-through entity level. (CCR §23649-9(e))
12.11.8 S-Corporation and Their Shareholder(s)

In the case of an S-Corporation, the determination of whether a taxpayer is a "qualified taxpayer" is made at the entity level. (R&TC §23649(c)(2) - repealed effective January 1, 2004) S-Corporations may claim only 1/3 of the credit against the 1.5% entity-level tax. (R&TC §23803(a)(1)) One hundred percent (100%) of the credit is passed through to the S-Corporation shareholders in accordance with their ownership interest. (R&TC §23803(a)(2)(F) and §23649(c)(2) - repealed effective January 1, 2004)

a. Recapture of MIC to S-Corporations and Their Shareholders

In general, the MIC is not allowed, or is subject to recapture, 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. “Disposition” includes:

- Removal of qualified property from California;
- Use of property primarily in a non-qualified activity;
- Disposition of qualified property to an unrelated party;
- Acquisition by the lessee of qualified property leased by such lessee (R&TC §23649(g) - repealed effective January 1, 2004; CCR § 23649-8(b)); and
- The sale of stock for which an election was made or deemed to have been made pursuant to IRC §338(g) or IRC §338(h)(10) will not be treated as a disposition of qualified property to an unrelated party for purposes of R&TC §23649(g) - repealed effective January 1, 2004.

If the disposition occurs during the taxable year the property is placed in service, no MIC is allowed. (R&TC §23649(g) - repealed effective January 1, 2004; CCR §23649-8(d)) If the disposition occurs in the subsequent taxable year, any MIC claimed must be added back to the taxpayer’s tax liability in the year of disposition. However, if there is any MIC carryover, then the available credit carryover must first be reduced to the full extent before adding any recaptured amount to the current year tax liability. (CCR §23649-8(e))
The amount of any MIC that is recaptured by the S-Corporation is added to the 1.5% corporate level tax. However, the recapture amount that is added to the tax must first be reduced by the two-third amount by which the S-Corporation was required to reduce the credit. (CCR §23649-8(f)(2)(A)) The amount of MIC subject to recapture is allocated among the shareholders in the same ratio that the MIC was allocable to each shareholder. (CCR §23649-8(f)(2)(B)) This amount is added to the tax of the shareholder for the taxable year in which the qualified property is disposed of, removed from this state or put to a non-qualifying use. (Note: For an S-Corporation, the recapture amount for the shareholder(s) will differ from the amount recaptured by the S-Corporation on Form 100S, Schedule J, since S-Corporations can only claim 1/3 of the credit.)

Example A

Q, an S-Corporation, has three equal shareholders, E, F, and G. Q is allowed a MIC in 2000 that can be utilize to reduce its 1.5% S-Corporation tax liability. E, F and G each claim one-third (1/3) share of the MIC allowed to Q and each is able to utilize their entire distributive share of the credit on their 2000 California tax returns.

In 2001, within one year of the date the qualified property was placed in service in California, Q uses the property in a non-qualified activity. Under these facts, Q, E, F and G must each recapture the MIC allowed and claimed on their respective 2000 California tax returns by adding the recapture amount to their 2001 California “tax” or “net tax.”

(Note: If there is any MIC carryover amounts, then those amounts are first reduced to the full extent before adding any recaptured amount to the current tax liability for Q, E, F and G.)
12.12 RESEARCH AND DEVELOPMENT CREDIT

California allows taxpayers to claim a credit for their qualified research expenses using either the regular research credit method or the alternative incremental credit method (R&TC §23609).

The regular credit is an incremental credit tied to a taxpayer’s increase in qualified research expenditures, expressed as a percentage of revenues, as compared with a historical fixed base. (IRC §41(a)(1))

The alternative incremental credit is based on a three-tiered rated schedule for all research expenses exceeding one percent of sales. (IRC §41(c)(4)) That is, the alternative incremental credit is based on a specified formula, which does not depend on the taxpayer’s incremental research and development expenditures.

12.12.1 Fed / State Differences
12.12.2 Qualified Research Expenditures
12.12.3 Alternative Incremental Credit
12.12.4 Credit Computation
12.12.5 Members of a Controlled Group
12.12.6 Reduced Credit
12.12.7 S-Corporations

12.12.1 Fed / State Differences

Because of the numerous federal and state differences, as well as several law changes since the enactment R&TC §23609 and IRC §41, you should refer to the statue and accompanying regulations for each tax year under audit.

The following are the most current modification from Federal to State Law regarding the R&D Credit:

- For tax years beginning before January 1, 1997 (R&TC §23609(a)(1))
  - The reference to 20% contained within IRC §41(a)(1) is modified to 8%
The reference to 20% contained within IRC §41(a)(2) is modified to 12%

- For tax year beginning on or after January 1, 1997 and before January 1, 1999 (R&TC §23609(b)(1))
  - The reference to 20% contained within IRC §41(a)(1) is modified to 11%
  - The reference to 20% contained within IRC §41(a)(2) is modified to 24%

- For tax year beginning on or after January 1, 1999 and before January 1, 2000 (R&TC §23609(b)(2))
  - The reference to 20% contained within IRC §41(a)(1) is modified to 12%
  - The reference to 20% contained within IRC §41(a)(2) is modified to 24%

- For tax year beginning on or after January 1, 2000 (R&TC §23609(b)(3))
  - The reference to 20% contained within IRC §41(a)(1) is modified to 15%
  - The reference to 20% contained within IRC §41(a)(2) is modified to 24%

- The definition of Qualified Research Expenses, as identified under IRC §41(b)(1), shall be modified to exclude any amount paid or incurred for the purchase or use of tangible personal property used in the teleproduction or other post-production process that is eligible for the exemption from sales or use tax. (R&TC §23609(c)(1))
- The term “qualified research” and “basic research” includes only research conducted in California (R&TC §23609(c)(2)).

- The provisions of IRC §41(e)(7)(A) are modified so that "basic research"; for the purpose of this section, includes any basic or applied research including scientific inquiry or original investigation for the advancement of scientific or engineering knowledge or the improved effectiveness of commercial products, except that the term does not include any of the following (R&TC 23609(d)):
  - Basic research conducted outside of California,
o Basic research in the social sciences, arts or humanities,
o Basic research for the purpose of improving a commercial product with respect to style, taste, cosmetic, or seasonal design factor, or
o Any expenditure paid or incurred for the purpose of ascertaining the existence, location, extent or quality of any deposit of ore or other mineral, including oil & gas.

• In the case of a taxpayer engaged in any biopharmaceutical research activities, the definition of "qualified organization" under provision of IRC §41(e)(6) is modified to include hospitals run by public universities and certain cancer centers (R&TC §23609(e)(1)).

• The R&D credit may be carried forward to succeeding years until the credit is exhausted. (R&TC §23609(f)).

• For each taxable year beginning on or after January 1, 1998, the reference to “§501(a)” in IRC §41(b)(3)(C), relating to contract research expenses, is modified to read “this part or Part 10 (commencing with R&TC §17001 ).” (R&TC §23609(g)).

• For each taxable year beginning on or after January 1, 2000 (R&TC 23609(h)(1))
  o The reference to “2.65 percent” in IRC §41(c)(4)(A)(i) is modified to read “one and forty-nine hundredths of one percent.”
  o The reference to “3.2 percent” in IRC §41(c)(4)(A)(ii) is modified to read “one and ninety-eight hundredths of one percent.”
  o The reference to “3.75 percent” in IRC §41(c)(4)(A)(iii) is modified to read “two and forty-eight hundredths of one percent.”

• IRC §41(c)(4)(B) shall not apply and in lieu thereof, an election under IRC § 41(c)(4)(A) may be made for any taxable year of the taxpayer beginning on or after January 1, 1998. That election shall apply to the taxable year for which made and all succeeding taxable years unless revoked with the consent of the Franchise Tax Board. (R&TC 23609(h)(2))

• IRC §41(c)(6), relating to gross receipts, is modified to take into account only those gross receipts from the sale of property held
primarily for sale to customers in the ordinary course of the taxpayer's trade or business that is delivered or shipped to a purchaser within this state, regardless of f.o.b. point or any other condition of the sale. (R&TC 23609(h)(3))

- IRC §41(h), relating to termination, shall not apply. (R&TC §23609(h)) The California R&D credit applies to expenses paid or incurred in taxable years beginning on or after January 1, 1987 and is available indefinitely thereafter, whereas the federal credit does not apply to amounts paid or incurred after June 30, 1995 and before July 1, 1996, or after December 31, 2007 (R&TC §23609 and IRC §41(h)(1)).

- IRC §41(g), relating to special rule for passthrough of credit, is modified by each of the following: (R&TC 23609(g))
  o The last sentence shall not apply and,
  o If the amount determined under IRC §41(a) for any taxable year exceeds the limitation of IRC §41(g), that amount may be carried over to other taxable years under the rules of subdivision (f), except that the limitation of IRC §41(g) shall be taken into account in each subsequent taxable year.

Additionally, R&TC §23036(d)(1)(D) allows the R&D Credit to reduce tax below the tentative minimum tax.

12.12.2 Qualified Research Expenditures

Research activity is considered “qualified research” if it meets all of the following four requirements of IRC §41(d)(1):

1. Qualify as a business deduction under IRC §174.
2. Be undertaken to discover information that is technological in nature. IRC §41(d)(1)(B)(i)
3. Be undertaken to discover information intended to be useful to develop a new or improved business component of the taxpayer. IRC §41(d)(1)(B)(ii)
4. Substantially all activities involve a process of experimentation. "Substantially all" means 80 percent or more the research activities involve a process of experimentation. IRC §41(d)(1)(C)

A qualified research activity must meet all four tests to be considered for the California R&D Credit. Apply the tests separately to each business component of the taxpayer.

Qualified Research Expenses generally include the sum of in-house research expenses (wages and supplies) and contract research costs. IRC §41(b)(1)

Wages – Qualified wages are for qualified services that directly relate to the research activities and are paid or incurred by the taxpayer. IRC §41(b)(2)(D) Qualified services include direct supervision, direct support, or direct performance of qualified research. IRC §41(b)(2)(B) General or administrative wages generally do not qualify. For example, an allocated portion of the purchasing or receiving department’s wages would not qualify because these are indirect costs and are incidental to research activity. Wages are defined under IRC § 3401(a).

Supplies – Supplies include tangible property that is consumed directly by the research activity or that is utilized in the development of a prototype. The supplies must be used in the conduct of qualified research. Supplies do not include land, improvements to land, or property subject to the allowance for depreciation. Utilities (phone and electricity), small tools, and allocations of total shipping cost do not qualify as supply expenses. IRC §41(b)(2)(C).

Contract research – Contract research expenses are amounts paid to non-employees (outside consultants) to perform qualified research. The taxpayer must enter into written agreement prior to performance of the research and must bear the costs even if the research is unsuccessful. The consultant must perform the research within California. If the research is conducted within and without California, only the expenditures incurred within California qualify. Only 65 percent of the California expense qualifies for the credit. IRC §§41(b)(3)(A)

The Revenue Reconciliation Act of 1989 expanded the definition of qualified research expense so "start-up" companies not yet in a trade or business may be entitled to the credit. Under this Act, a taxpayer is deemed to meet
the trade or business requirement with respect to in-house research expenses if, at the time the expenses are incurred, the principal purpose of the taxpayer in making such expenditures is to use the result of the research in the active conduct of a future trade or business of the taxpayer. (IRC §41(b)(4))

12.12.3 Alternative Incremental Credit

Instead of the regular credit, an S-Corporation may elect the alternative incremental credit in which it is assigned a smaller three-tiered fixed base percentage and a reduced three-tiered credit rate. Election for the alternative incremental credit may be made for tax years beginning on or after January 1, 1998. However, once made the election applies to the current taxable year and all subsequent years unless the FTB consents to revoke the election. (IRC §41(c)(4); R&TC §23609(h)(2))

12.12.4 Credit Computation

The current research credit amount is 15% of the excess of qualified research expenses for the taxable year over the base period research expenses. (R&TC §23609(b)(2)) The base amount is equal to the fixed base percentage multiplied by the taxpayer's average annual gross receipts for the four taxable years preceding the credit year (i.e., the year in which the amount of credit is being computed). (IRC §41(c)(1)) However, the base amount cannot be less than 50% of the current year qualified research expenses. (IRC §41(c)(2)) The fixed base percentage depends on whether the taxpayer is a “start-up” company or existing company.

A “start-up” company is one that has both gross receipts and qualified research expenses either: (1) for the first time in a taxable year beginning after 1983, or (2) for fewer than 3 taxable years beginning after 1983 and before January 1, 1989. The fixed-base percentage for a “start-up” company is 3% for each of the company’s first 5 taxable years beginning after 1993 for which it has qualified research expenses. See IRC §41(c)(3)(B)(ii) for a company’s fixed base percentage for its 6th through 10th years.

The fixed base percentage for an existing company is determined by dividing the aggregate qualified research expenses for taxable years beginning after
1983 and before 1989 by the aggregate gross receipts for those tax years. (IRC §41(c)(3)) However, the maximum fixed base percentage is 16%.

For purposes of the base amount and fixed base percentage, the average annual gross receipts is computed using the gross receipts of the four taxable years preceding the tax year for which the credit is being determined. (IRC §41(c)(1)(B)) R&TC §23609(h)(3) modifies the definition of gross receipts. California gross receipts 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 delivered or shipped to a purchaser within California, regardless of free on board shipping point or other condition of sale. This includes sales to the U.S. government, which could be identified as delivered in California.

Excluded receipts are items such as California “throwback” sales for apportionment purposes, as well as, receipts from services, rents, operating leases and interest. Royalties and license payments are also generally excluded from the definition of gross receipts for research credit purposes.

Additionally, transactions operating as a sale of property based on the terms of a contract will need to be evaluated on a case-by-case basis.

12.12.5 Members of a Controlled Group

California conforms to the federal rules for assigning the research credit among members of a controlled group. (IRC §41(f)) All members of a "controlled group" are treated as a single taxpayer for purposes of the research credit. For aggregation purposes, the “gross receipts” figures used in the base amount calculations (the “average annual gross receipts” and the “aggregate gross receipts” of the fixed-base percentage) should reflect those from the entire “controlled group” (even when only one corporation has research expenses) and the total credit generated is computed as if the controlled group is a single taxpayer. Using the “gross receipts” of the entire controlled group reflects an accurate comparison of the research expenditures to the business as a whole. The total credit amount is then assigned to the members of the controlled group based upon their proportionate share of the qualified research expenses and basic research payments. It should be noted the aggregation rules apply to controlled
trades and businesses as well as controlled corporations. Controlled trades and businesses include sole proprietorships, partnerships, and estates and trusts.

12.12.6 Reduced Credit

For taxable years after December 31, 1989, IRC §280C(c) [R&TC §24440(b)(1)] disallows a deduction under IRC §174 for the taxable year equal to the amount of the R&D Credit determined for the year, so the taxpayer will not receive a tax benefit for the expenses twice. This creates an addition to income in the amount of the credit (in order to decrease the IRC § 174 research and development expense deduction). Note that due to differences in the federal and California credit amounts, the California return may require state adjustments, especially if the California return begins with the federal taxable income.

Taxpayers may avoid the reduction of their research and development expenses by electing to take a reduced credit in accordance with IRC §280C(c)(3). This election reduces the research credit by the amount of tax savings created by the double tax benefit. The maximum tax rates are used for this computation. Applicable credit reduction percentages (R&TC §17270(c) and R&TC §24440(b)(2)): corporations multiply their research credit by 91.16 percent (.9116) (R&TC §23151(f)), individuals and estates or trusts multiply their research credit by 90.7 percent (.907) (R&TC §17041), and S corporations multiply their research credit by 98.5 percent (.985) (R&TC §23802(b)(1)) to arrive at the reduced credit amount. This irrevocable election must be made on the original California return filed on or before the due date for filing the return, including extensions. The election cannot be made on an amended return.

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

The shareholder(s) election of the reduced credit must be consistent with that of the S-Corporation’s. For example, if ABC, Inc., an S-Corporation, elects the reduced credit, then its shareholder(s) must also reduce their pro

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rata share of the research credit. However, the credit reduction percentage may differ from that of the S-Corporation.

The taxpayer must note in the supplementary information section on the Schedule K-1 the shareholder’s applicable credit reduction percentage. If the taxpayer does not know what type of entity the shareholder is, then the taxpayer should report the pro rata share amount of the research credit on the Schedule K-1 without the credit reduction.

**Example A**

T, an S-Corporation, has one shareholder - H. T generated $30,000 in research credit for tax year 2006. T elects the reduced research credit. T computes its research credit as follows:

Step 1: $30,000 x 1/3 = $10,000  
Step 2: $10,000 x 98.5% (.985) = $9,850

This amount, $9,850, is the research credit available to T for its 2006 taxable year.

H, the sole shareholder, materially participates in the business, holds no interest in any passive activity, and does not have any non-passive activity credit carryover from previous years. The election by T to the reduced credit also applies to H and his pass-through credit is computed as follows:

Step 1: $30,000 x 100% = $30,000  
Step 2: $30,000 x 90.7% = 27,210

This amount is the pass-through research credit available to H for his 2006 taxable year. Note: Amounts received from S-Corporations may be limited due to IRC §41(g) and the related regulations.

**12.12.7 S-Corporations**

S-Corporations may claim 1/3 of the research credit against the 1.5% entity-level tax after applying the limitations relating to passive activity...
losses and credits. However, S-Corporations are not eligible for the “basic research” credit. (IRC §41(e)(7)(E)(i)) S-Corporations can pass through 100% of this credit to their shareholders on a pro-rata basis.

The amount of research credit passed through to the shareholder on the Schedule K-1 may be limited to the amount of tax attributable to the shareholder’s interest in the S-Corporation (IRC §41(g)). To determine the shareholder’s credit limitation, see FTB Form 3523 – Line 40 instructions.