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1000 INTRODUCTION TO ECONOMIC DEVELOPMENT AREAS

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 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).
- Program Areas.
- Enterprise Zone

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.

1100 MECHANISMS FOR DESIGNATING ECONOMIC DEVELOPMENT AREAS

1110 Enterprise Zone Act / Employment and Economic Incentive Act

The *Enterprise Zone Act* and the *Employment and Economic Incentive Act*, which became effective on March 20, 1984, established the mechanisms for designating economic development areas referred to as *Enterprise Zones* (EZs) and *Program Areas* in California. Special tax incentives are available for entities and individuals that operate or invest in a business located within designated EZs or Program Areas.

No more than 42 EZs may be designated at any one time (per Government Code Section 7073). Currently, there are 42 designated or conditionally designated EZs. See *Enterprise Zone Locations and Designation Dates*, Section 1310.

EZ designations are effective for 15 years. An additional 5year extension may be allowed if the EZ meets certain criteria. The California Department of Housing & Community Development approves extensions via an application process.

1120 Local Agency Military Base Recovery Area Act

The Local Agency Military Base Recovery Area Act, which became effective on October 11, 1993, established the mechanisms for designating Local Agency Military Base Recovery Areas (LAMBRAs) to stimulate growth and development in areas that experience military base closures. A taxpayer that conducts a trade or business within a LAMBRA, and within the first two taxable years after commencing business has a net increase in jobs (defined as 2,000 paid hours per employee per year) of one or more employees in the LAMBRA, may qualify for special incentives.

The law provides for the designation of eight (8) LAMBRAs (Government Code Section 7113.5). Tax incentives are not available until an area has received final designation from the California Department of Housing & Community Development. Designations are effective for eight years. See *LAMBRA Locations and Designation Dates,* Section 1320.

1130 Enterprise Zone Act – Manufacturing Enhancement Area

Effective January 1, 1998, the law provides for the designation of two (2) Manufacturing Enhancement Areas (Government Code Section 7073.8). Both of the Manufacturing Enhancement Areas (MEAs) have been designated. A special tax incentive is available for entities and individuals that operate or invest in a business located within the designated MEA.

Designations expire December 31, 2012. See *MEA Locations and Designation Dates,* Section 1330.

1140 Targeted Tax Area

The Targeted Tax Area (TTA) was established to stimulate development in a selected economically depressed area. Special tax incentives are available for entities and individuals that operate or invest in a business located within the designated TTA.

The law provides for the designation of one (1) Targeted Tax Area (Government Code Section 7097). The Targeted Tax Area designation expires October 31, 2013. See *TTA Locations and Designation Date,* Section 1340.

1200 EXPIRED ECONOMIC DEVELOPMENT AREAS

The following expired EDAs were operative in prior years:

- Los Angeles Revitalization Zone (LARZ);
- Program Areas; and
- Enterprise Zones.

The LARZ was established in the areas of Los Angeles County that suffered from civil disturbances in April and May, 1992. Taxpayers conducting business activities in this zone could qualify for special state tax incentives similar to the EZ. The LARZ became operative on May 1, 1992, and the tax incentives were applicable for taxable years beginning on or after January 1, 1992 and before January 1, 1998. The LARZ geographic area expired on December 1, 1998. See *LARZ Locations and Designation Date,* Section 1350.

The first Program Areas were designated October 15, 1986. Program Area tax incentives were available for taxable years beginning before January 1, 1997. Taxpayers conducting business activities within a Program Area had to be certified by the California Technology, Trade & Commerce Agency as meeting specified work force standards to take advantage of the Program Area tax incentives. Program Areas were converted into EZs effective for taxable years beginning on or after January 1, 1997. All carryover credits and NOLs were converted into EZ carryovers for use in future years. The expiration dates of the Program Areas remained unchanged as a result of the conversion. *See Program Area Locations and Designation Dates,* Section 1360.

A large number of EZs expired in 2006 and 2007.

Location of Expired EZ	**Designation Date**	**Expiration Date**
Altadena/Pasadena	04/10/1992	04/09/2007
Bakersfield/Kern (SE Bakersfield)	10/15/1986	10/14/2006
Calexico	10/15/1986	10/14/2006
Coachella Valley	11/11/1991	11/10/2006
Delano	12/17/1991	12/16/2006
Eureka	10/15/1986	10/14/2006
Fresno	10/15/1986	10/14/2006
Long Beach	01/08/1992	01/07/2007
Los Angeles-Central City	10/15/1986	10/14/2006
Los Angeles-Mid Alameda Corridor The City of Lynwood	10/15/1986 10/15/1986	10/14/2006 10/14/2001
Los Angeles-NE Valley	10/15/1986	10/14/2006
Merced/Atwater	12/17/1991	12/16/2006
Oroville	11/06/1991	11/05/2006
Porterville	10/15/1986	10/14/2006
Redding/Anderson (Shasta Metro)	11/06/1991	11/05/2006
Richmond	03/02/1992	03/01/2007
Sacramento-Northgate	10/15/1986	10/14/2006
San Bernardino/Riverside (Agua Mansa)	10/15/1986	10/14/2006
San Diego- Metro	10/15/1986	10/14/2006
San Diego- South Bay	01/28/1992	01/27/2007
San Francisco	05/28/1992	05/27/2007
San Jose	12/31/1986	12/30/2006
Yuba/Sutter	10/15/1986	10/14/2006

The EZ incentives expire as follows:

	Expiration of Enterprise Zone Incentives
Hiring Credit	The enterprise zone hiring credit is allowed for a full five-year period of employment from the date of hire for those employees hired prior to the expiration date of the enterprise zone as provided for by statute.
Sales or Use Tax Credit	The enterprise zone sales or use tax credit is allowed for qualified property purchased and placed in service up to the expiration date of the enterprise zone as provided for by statute.
Business Expense Deduction	The enterprise zone business expense deduction is allowed for qualified property purchased and placed in service up to the expiration date of an enterprise zone.
Net Operating Loss	The enterprise zone net operating loss is allowed for losses attributed to a taxpayer's trade or business activities within the enterprise zone prior to the expiration of the enterprise zone. To determine this loss, the entire full year loss is computed as if the taxpayer operated in the enterprise zone the entire year, and then this loss is apportioned to the enterprise zone based on the number of days the taxpayer conducted business in the enterprise zone (numerator), as compared to the number of days in the tax year (denominator).
Net Interest Deduction	The enterprise zone net interest deduction is allowed for interest payments received on or before the expiration date of the enterprise zone.

1300 GEOGRAPHIC BOUNDARIES

A business may qualify for special tax incentives if it operates or invests in a trade or business located within the geographic boundaries of one of the EDAs. EDA geographic boundary information is available from:

Department of Housing and Community Development
Division of Financial Assistance
State Enterprise & Economic Development Section
1800 Third Street, Suite 390-1
Sacramento, CA 95811

Telephone: (916) 322-1554
FAX: (916) 327-6600
Website: www.hcd.ca.gov

1310 Enterprise Zone Locations and Designation Dates

Beginning in 2006, a large number of EZs were set to expire, however the expired EZs could apply with HCD for a new conditional designation. Many EZs were granted conditional designation. AB 1550 was enacted to address issues related to the gap period between final designation of a new zone and the expiration date of the old zone (thus resulting in an interruption of tax incentives). It allowed conditionally designated EZ, in certain situations to offer all enterprise zone benefits the day after the expiration date of the expiring zone, or until HCD declines to designate. For example, if an EZ expired on October 14, 2006, new EZ incentives would be available from October 15, 2006 forward. With the new law there are now 4 types of zones:

- Current EZ Designations - Continue to earn incentives until the expiration of the EZ. A separate FTB 3805Z is necessary to take these incentives.
- Expired EZs - May continue earning, using incentives, or carryover credits after expiration. A separate FTB 3805Z is necessary to take these incentives. (See EDAM 1200 for a listing of expired EZs and how the incentives expire).
- Conditional EZ Designations - These EZs begin to earn incentives the day after the former EZ expired. The EZ will expire 15 years after the expiration of the former EZ or on the date HCD declines to designate[1]. A separate FTB 3805Z is necessary to take these incentives.
- EZs Pending Final Designation - These EZs have not received final designation and will not be entitled to incentives unless or until HCD issues a final designation letter.

[1] Government Code section 7074.2 states as follows:
(c) Notwithstanding any other provision of law, an expiring enterprise zone that applies for a new enterprise zone designation pursuant to Section 7073 or 7073.1, and receives a conditional designation letter from the department, may offer, and a taxpayer doing business within the geographic boundaries of the new zone referenced in the conditional designation letter shall be eligible to receive, all enterprise zone benefits until the department makes a final designation or declines to redesignate the zone**.** The department shall make the effective date of the new zone the date of expiration of the previous designation and the term of the new zone shall begin on that date.

Current Designations

Location	**Designation Date**	**Expiration Date**
Antelope Valley	02/01/1997	01/31/2012
Barstow	02/01/2006	01/31/2021
Compton	08/01/2007	07/31/2022
Fresno County	06/27/2007	06/26/2022
Imperial Valley	03/01/2006	02/28/2021
Kings County	06/22/1993	06/21/2008
Lindsey	10/06/1995	10/05/2010
Los Angeles-Eastside	01/11/1998	01/10/2008
Los Angeles-Harbor Area	03/04/1989	03/03/2009
Madera	03/04/1989	03/03/2009
Pittsburg	01/11/1998	01/10/2008
Oakland	09/28/1993	09/27/2008
Sacramento Army Depot	10/04/1994	10/03/2009
Sacramento-Florin/Perkins	04/05/1989	04/04/2009
Santa Ana	06/08/1993	06/07/2008
Santa Clarita	07/01/2007	06/31/2022
Shafter	10/04/1995	10/03/2010
Siskiyou County (Shasta Valley)	06/22/1993	06/21/2008
Stanislaus	11/16/2005	11/15/2020
Stockton	06/22/1993	06/21/2008
Watsonville	05/01/1997	04/30/2012
West Sacramento	01/11/1998	01/10/2008

Conditional Designations

Location	**Designation Date**	**Expiration Date ***
Calexico	10/15/2006	10/14/2021
Coachella Valley	11/11/2006	11/10/2021
Delano	12/17/2006	12/16/2021
Eureka	10/15/2006	10/14/2021
Fresno City	10/15/2006	10/14/2021
Long Beach	01/08/2007	01/07/2022
Los Angeles	10/15/2006	10/14/2021
Merced County	12/17/2006	12/16/2021
North Sacramento (City and County)	10/15/2006	10/14/2021
Oroville	11/06/2006	11/05/2021
Pasadena	04/10/2007	04/09/2022
Richmond	03/02/2007	03/01/2022
San Bernardino	10/15/2006	10/14/2021
San Diego	10/15/2006	10/14/2021
San Francisco	05/28/2007	05/27/2022
San Jose	12/31/2006	12/30/2021
Shasta	11/06/2006	11/05/2021
Yuba/Sutter	10/15/2006	10/14/2021

* The EZ will expire 15 years after the conditional designation date (as shown) or on the date HCD declines to designate.

Pending Final Designations

New Designations	**Designated Date**	**Expiration Date**
Arvin	Unknown	Unknown
Southgate/Lynwood	Unknown	Unknown

1320 LAMBRA Locations and Designation Dates

The law provides for the designation of eight (8) LAMBRAs (Government Code Section 7113.5). There are currently eight (8) LAMBRAs, designated on the dates shown:

Location	Designation Date	Expiration Date
Castle Airport Aviation & Development Center*	06/01/1996	05/31/2012
Southern California Logistics Airport*	02/01/1996	02/20/2010
Mare Island	01/01/1999	01/31/2008
San Bernardino International Airport & Trade Ctr.	04/01/2000	03/31/2008
Alameda Point	06/01/2000	05/31/2008
Mather Field & McClellan Park	07/01/2000	06/30/2008
Liberty Station	06/01/2001	05/31/2009
Tustin Marine Corps Air Station in Tustin	09/01/2001	08/31/2009

***** The Southern California Logistics Airport LAMBRA was set to expire on January 31, 2004 and the Castle Airport Aviation & Development Center LAMBRA was set to expire on May 31, 2004. The California Department of Housing & Community Development (HCD) extended the Southern California Logistics Airport LAMBRA expiration date to February 20, 2010, and the Castle Airport Aviation & Development Center LAMBRA to May 31, 2012 (pursuant to the requirements of AB 2875 - Gov't Code Section 7110.5).

NOTE: LAMBRA tax incentives are not available until an area has received final designation from the HCD.

1330 MEA Locations and Designation Dates

The law provides for the designation of two (2) Manufacturing Enhancement Areas (Government Code Section 7073.8). Both of the Manufacturing Enhancement Areas were designated on the dates shown:

Location	Designation Date	Expiration Date
Brawley	10/01/1998	12/31/2012
Calexico	10/01/1998	12/31/2012

1340 TTA Locations and Designation Date

The law provides for the designation of one (1) Targeted Tax Area (Government Code Section 7097).

All of the incorporated cities in Tulare County and portions of the unincorporated areas of Tulare County received final designation as the TTA, effective November 1, 1998. The TTA expires December 31, 2012. The eight (8) incorporated cities in Tulare County are:

- Dinuba
- Exeter
- Farmersville
- Lindsay
- Porterville
- Tulare
- Visalia
- Woodlake

1350 LARZ Locations and Designation Dates

The zone boundaries were designated 12/31/92 but were effective retroactively for qualified costs paid or incurred on or after 05/01/92 or 09/01/92. **Note**: Effective 1/1/96, the LARZ geographic area was re-determined (downsized) to eliminate previously qualified addresses. For taxpayers who operate in the portion of the LARZ that was excluded when the LARZ was downsized, LARZ benefits that were incurred when the LARZ designation was effective are still allowed after downsizing (carryover amounts). With regard to the applicability of LARZ benefits incurred after the downsize of the LARZ, generally, they are no longer available as of the first day of the taxable year beginning on or after the determination date (01/01/1996).

- Compton
- Hawthorne
- Huntington Park
- Inglewood
- Lawndale
- Long Beach
- Los Angeles
- Lynwood
- Pomona
- Signal Hill
- Unincorporated Los Angeles County

Note: The LARZ expired on December 1, 1998.

1360 Program Area Locations and Designation Dates

Portions of the following areas were designated as Program Areas on the dates shown. Designations were effective for fifteen years.

Location	**Designation Date**
Los Angeles-East Area	01/11/1988
Los Angeles- Greater Watts	10/15/1986
Los Angeles-Wilmington/San Pedro/Harbor	03/03/1989
Madera	03/03/1989
Pittsburg	01/11/1988
Sacramento-Northgate	10/15/1986
Sacramento-Oak Park/Florin-Perkins	04/05/1989
S.E. Bakersfield	10/15/1986
West Sacramento	01/11/1988

Note: 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.

1400 TAX INCENTIVES

The specific tax incentives available and the relevant California Revenue & Taxation Code (CR&TC) sections, include the following:

EZ
- Hiring Credit - CR&TC §17053.74 & 23622.7
- Sales or Use Tax Credit - CR&TC §17053.70 & 23612.2
- Business Expense Deduction - CR&TC §17267.2 & 24356.7
- Net Interest Deduction - CR&TC §17235 & 24384.5
- Net Operating Loss - CR&TC §17276.2 & 24416.2

LAMBRA
- Hiring Credit - CR&TC §17053.46 & 23646
- Sales or Use Tax Credit - CR&TC §17053.45 & 23645
- Business Expense Deduction - CR&TC §17268 & 24356.8
- Net Operating Loss - CR&TC §17276.5 & 24416.5

MEA
- Hiring Credit - CR&TC §17053.47 & 23622.8

TTA
- Hiring Credit - CR&TC §17053.34 & 23634
- Sales or Use Tax Credit - CR&TC §17053.33 & 23633
- Business Expense Deduction - CR&TC §17267.6 & 24356.6
- Net Operating Loss - CR&TC §17276.6 & 24416.6

LARZ (REPEALED)
- General Hiring Credit - CR&TC §17053.17 & 23623.5
- Construction Hiring Credit - CR&TC §17053.10 & 23625
- Sales or Use Tax Credit - CR&TC §17052.15 & 23612.6
- Business Expense Deduction - CR&TC §17266 & 24356.4
- Net Interest Deduction - CR&TC §17233 & 24385
- Net Operating Loss - CR&TC §17276.4 & 24416.4

1500 REFERENCES

Form Number	Form Name
FTB 3553	Enterprise Zone Employee Credit
FTB 3805Z	Enterprise Zone Business Booklet
FTB 3806	Los Angeles Revitalization Zone Business Booklet
FTB 3807	Local Agency Military Base Recovery Area Business Booklet
FTB 3808	Manufacturing Enhancement Area Business Booklet
FTB 3809	Targeted Tax Area Business Booklet

2000 ENTERPRISE ZONE HIRING CREDIT

References: 17053.74; 23622.7

The California Revenue & Taxation Code (CR&TC) provides a hiring credit for qualified taxpayers who employ qualified employees within a designated Enterprise Zone (EZ) and pay qualified wages to these employees. EZs were established in California to stimulate development in selected economically depressed areas.

The EZ hiring credit applies to those employees hired after the designation date of the EZ.

2100 GEOGRAPHIC BOUNDARIES AND DESIGNATION DATES

For a listing of EZs and designation dates, refer to EDAM Section 1310. To verify an address, refer to EDAM Section 1300.

2200 QUALIFIED TAXPAYER

References 17053.74(b) & (c); 23622.7(b) & (c)

A qualified taxpayer:

- A person or entity engaged in a trade or business within an EZ
- Obtains and retains certification as discussed in section 2430 which provides that a qualified employee meets the eligibility requirements applicable immediately preceding commencement of employment with the taxpayer as discussed in section 2400.

  Note: Failure to obtain the voucher results in the taxpayer not meeting all the qualifications of a qualified taxpayer eligible for the hiring credit, thus no credit is allowed. A taxpayer must obtain a certification (voucher).

2210 Pass-Through Entities

The determination of whether a taxpayer is a qualified taxpayer is made at the entity level. The term pass-through entity means any partnership or S corporation. The hiring credit is allowed to the pass-through entity and passed through to the partners or shareholders.

2220 Controlled Groups

References 17053.74(d)(1)(A); 17053.74(d)(1)(C); 23622.7(d)(1)(A); 23622.7(d)(1)(C)

All employees of trades or businesses under common control, or members of the same controlled group of corporations, are treated as employed by a single taxpayer.

A controlled group of corporations is defined in IRC § 1563(a) as modified by the California Revenue & Taxation Code, to replace "*at least 80%*" with "*more than 50%*". The determination is made without regard to subsections (a)(4) and (e)(3)(C) of IRC § 1563.

Note: Controlled groups of taxpayers may not transfer employees between members to trigger or increase the credit.

2230 Acquired Businesses

References 17053.74(d)(2); 23622.7(d)(2)

For purposes of the hiring credit, if a major portion of a business is acquired from another employer, the employment relationship between the employee and the new employer shall not be treated as terminated if the employee continues employment in that business. Also, if a major portion of a separate unit of a business predecessor is acquired, the employment relationship between the employee and the new employer shall not be treated as terminated if the employee continues employment in that business.

Note: The new employer steps into the shoes of the old employer for purposes of incurring future credits.

2300 QUALIFIED WAGES

References 17053.74(b)(1); 17053.74(b)(2); 17053.74(f); 23622.7(b)(1); 23622.7(b)(2)

Qualified wages are wages paid or incurred to qualified employees during the consecutive 60-month period beginning with the first day the employee commences employment with the taxpayer. For qualified employees hired before the expiration date of the EZ, qualified wages paid or incurred within the 60-month period beginning with the first day the employee commences employment with the taxpayer shall continue to qualify for the credit after the zone expiration date, as if the EZ designation were still in existence and binding.

In general, qualified wages means that portion of hourly wage that does not exceed 150% of the minimum wage.

- For taxable years beginning on or after January 1, 1996, for taxpayers engaged in aircraft manufacturing activities within the Long Beach EZ, as described in the Standard Industrial Classification (SIC) Manual (1987 edition) Code sections 3721 through 3728, and 3812, qualified wages (for up to 1,350 qualified employees) means that portion of hourly wage that does not exceed 202% of the minimum wage.
- Minimum wage means the wage established by the Industrial Welfare Commission. When the California minimum wage is higher than federal minimum wage, use the California minimum wage for purposes of this credit.
- To determine a salaried employee's hourly wage, a reasonable method of doing so is to divide the total salary by the hours on which the salary is based, normally 2,000 hours per year.

2310 Estates and Trusts

In the case of an estate or trust, apportion the qualified wages between the estate/trust and the beneficiaries on the basis of the income allocable to each. Consequently, any beneficiary to whom wages are apportioned is treated as the employer with respect to those wages.

2320 Non-Qualified Wages

Qualified wages do not include any wages paid or incurred on or after the zone expiration date except as noted previously for qualified employees hired prior to the expiration of the EZ.

2330 Minimum Wage Chart

Effective Date	Minimum Wage	Maximum Hourly Wage (Hiring Credit)
July 1, 1988 to September 30, 1996	$4.25	$6.37 (150% of $4.25)
October 1, 1996 to February 28, 1997	$4.75	$7.12 (150% of $4.75)
March 1, 1997 to August 31, 1997	$5.00	$7.50 (150% of $5.00)
September 1, 1997 to February 28, 1998	$5.15	$7.72 (150% of $5.15)
March 1, 1998 to December 31, 2000	$5.75	$8.62 (150% of $5.75)
January 1, 2001 to December 31, 2001	$6.25	$9.37 (150% of $6.25)
January 1, 2002 to December 31, 2006	$6.75	$10.12 (150% of 6.75)
January 1, 2007 to December 31, 2007	$7.50	$11.25 (150% of 7.50)
Effective January 1, 2008	$8.00	$12.00 (150% of 8.00)

2400 QUALIFIED EMPLOYEE

References 17053.74(b)(4)(A); 23622.7(b)(4)(A)

A qualified employee is an individual who satisfies all of the following:

Annual Tests

- At least 90% of the individual's work for the taxpayer, during the taxable year, is directly related to the conduct of the taxpayer's trade or business located within an EZ.
- At least 50% of the individual's services for the taxpayer, during the taxable year, are performed within the boundaries of an EZ.

For employees who work in multiple locations for the same employer, the 50% test is met as long 50% of his/her services are performed within the boundaries of any EZ.

Example: An employee works for the same employer in three different locations; 30% in EZ 1, 40% in EZ 2, 30% outside EZ. The employee meets the 50% test because at least 50% of the services are performed in an EZ.

Time of Hire Tests

- The individual is hired after the area was designated as an EZ (or after the expansion date of an area of an EZ)
- Immediately prior to commencement of employment with the taxpayer, the individual is any of the following:

For taxable years beginning on or after January 1, 1997:

1. Eligible for services under the federal Job Training Partnership Act (JTPA), or its successor[2].
2. Eligible as a voluntary or mandatory registrant under the Greater Avenues for Independence (GAIN) Act of 1985, or its successor.
3. An economically disadvantaged individual 14 years of age or older.
4. A qualified dislocated worker (refer to the CR&TC 23622.7(b)(4)(a)(iv)(IV) or the 3805Z EZ Business Booklet for an expanded definition).
5. A disabled individual who is eligible for, enrolled in, or who has completed a state rehabilitation plan.
6. A service-connected disabled veteran.
7. A veteran of the Vietnam era.
8. A veteran who recently separated from military service.
9. An ex-offender.
10. A person eligible for, or a recipient of any of the following:
    - Federal Supplemental Security Income (SSI) benefits.
    - Aid to Families with Dependent Children (AFDC).
    - Food stamps.
    - State and local general assistance.
11. A Native American.
12. A resident of a Targeted Employment Area (TEA), as defined in Section 7072 of the Government Code.
13. An employee who qualified the taxpayer for the EZ hiring credit under former CR&TC §17053.8 & 23622.
14. An employee who qualified the taxpayer for the Program Area hiring credit under former CR&TC §17053.11 & 23623.
15. A member of a targeted group, as defined in IRC § 51(d) or its successor.

[2] JTPA was effective for employees hired on or before 6/30/2000. Workforce Investment Act (WIA) was effective for employees hired on or after 7/1/2000. WIA is the successor to JTPA.

A taxpayer who moves his/her (or a) business into an EZ may qualify to claim the hiring credit for an employee hired prior to the business moving into an EZ. A voucher must be obtained based on the employee's original hire date. The hiring credit is computed using the appropriate percentage depending on the numbers years of employment.

Example: Assume the employee was hired on 01/01/2000, the taxpayer moved its business in an EZ on 07/30/2003, and the EZ was designated prior to 2000. Assuming the taxpayer obtains a voucher and the employee meets all other requirements of a qualified employee, the taxpayer may start claiming the hiring credit on qualified wages beginning 07/30/2003 at 30% (3rd year of employment).

2410 Seasonal Employees

References 17053.74(b)(1)(B); 17053.74(b)(6); 23622.7(b)(1)(B); 23622.7(b)(6)

Seasonal employment means employment that has regular and predictable substantial reductions in business operations.

Reemployment of an individual in connection with any increase (including a regularly occurring seasonal increase) in business operations does not constitute commencement of employment for purposes of the EZ hiring credit.

2420 Leased Employees

The employer is the qualified taxpayer and may qualify for the hiring credit for leased employees, employees contracted through a Temp Employee Agency, or under a contractual Professional Employee Organization arrangement. The employer can be either the leasing company or the subscriber to the arrangement. Generally, the employer has the legal obligation to pay the payroll taxes of the employee, and the right to control and direct the workers (employee's) services.

Internal Revenue Service (IRS) Publication 15-A, *Employer's Supplemental Tax Guide* provides guidelines for establishing an employment relationship and provides examples to consider in determining the employer-employee relationship.

2430 Vouchering Form HCD EZ1

References 17053.74(c); 23622.7(c)

The *Form HCD EZ1 or VoucherApp 10-07* certifies the employee meets the eligibility requirements of a qualified employee as discussed in section 2400. The qualified taxpayer shall get *Form TCA EZ1* from one of the following applicable entities:

- The Employment Development Department (EDD)
- The local WIA administrative entity
- The local county GAIN office
- The local social services agency
- The local government administering the EZ

The qualified taxpayer needs to retain a copy of the certification and provide it upon request to the Franchise Tax Board.

Under the provisions of CR&TC §17053.74(c) and § 23622.7(c), a qualified employer is one that has obtained and retained a voucher to certify that their employee meets any one of the qualifying criteria. Failure to obtain the voucher results in the taxpayer not meeting all the qualifications of a qualified taxpayer eligible for the hiring credit, thus no credit is allowed. A taxpayer must obtain certification (voucher).

The Housing and Community Development Department (HCD) issued regulations with respect to vouchers issued on or after January 1, 2007. See the HCD website for further information. http://www.hcd.ca.gov/fa/cdbg/ez/

2500 CREDIT COMPUTATION

References 17053.74(a); 23622.7(a)

For each taxable year a hiring credit is allowed to a qualified taxpayer for hiring a qualified employee for employment within an EZ. The credit is equal to the sum of each of the following:

- 50% of the qualified wages during the first year of employment.
- 40% of the qualified wages during the second year of employment.
- 30% of the qualified wages during the third year of employment.
- 20% of the qualified wages during the fourth year of employment.
- 10% of the qualified wages during the fifth year of employment.

The credit percentage is based on the employee's date of employment and subsequent anniversary dates. The taxpayer's tax year does not control the applicable credit percentages. With the exception of the first and last year of the credit, within one tax year, two percentage ranges for the computation of the credit are generally used.

> ***Example***: An employee was hired 07/01/2004, and the taxpayer is completing the tax return for the year ending 12/31/2005. For the period 01/01/2005 to 06/30/2005, the hiring credit is based on 50% of qualified wages. For the period 07/01/2005 to 12/31/2005, the hiring credit is based on 40% of qualified wages.

Once the employee commences employment, the credit percentage range begins and generally is not interrupted in the event of a subsequent layoff and rehire of the employee.

> ***Example***: An employee is hired 07/01/2004, is temporarily laid off 02/01/2005, and is rehired 04/01/2005. The 50% credit range runs from 07/01/2004 to 06/30/2005 regardless of the layoff period between 02/01/2005 and 03/31/2005.

2510 Reduction for Other Tax Credits

References 17053.74(h); 23622.7(h)

The EZ hiring credit is reduced by the credits allowed under the following sections for the same employee:

- CR&TC §17053.10 & §23625 - LARZ construction hiring credit
- CR&TC §17053.17 & §23623.5 - LARZ general hiring credit
- CR&TC §17053.46 & §23646 - LAMBRA hiring credit
- The federal credit allowed under IRC § 51 - Work Opportunity Tax Credit (WOTC)

The WOTC credit reduction depends upon the dates of our conformity IRC § 51 as follows:

Employees With Hire Dates	**IRC Conformity Year**	
After 12/31/2005	2005	No Reduction
01/01/2005-12/31/2005	2005	Reduction
07/01/1998-12/31/2004	2001 1998	No Reduction No Reduction
On or before 06/30/1998	1998	Reduction

2520 Wage Expense Reduction

References 17053.74(h); 23622.7(h)

The taxpayer must reduce any deduction for wages by the amount of the EZ hiring credit allowed (includes any current year credit carried forward).

2530 Business Income Activity Limitation

References 17053.74(j); 23622.7(j)

The amount of the hiring credit or the sales or use tax credit claimed (Section 3000), including any credit carryover from prior years, may not exceed the amount of tax on the taxpayer's EZ business income in any tax year. The EZ business income is that portion of the taxpayer's California source business income apportioned to the EZ. Non-business income or loss is not included in the calculation of business income from the EZ. Each taxpayer claiming the credit must compute the EZ business income and resulting tax.

Example: Corporation A operates entirely within an EZ. In order to determine the amount of hiring credit allowable, the business income and the tax on that business income must be determined. Corporation A has the following items of income and expense:

Income from business operations	$30,000
Interest from investment which is unrelated to business operations	2,000
Business expenses	(17,000)
Net taxable income before taxes	**$15,000**

Corporation A's income attributed to business operations is:

Income from business operations	$30,000
Business expenses	(17,000)
Net Business Income	**$13,000**

To determine the EZ hiring credit allowable, the net business income is multiplied by the current tax rate.

Net Business Income	$13,000
x 8.84%	x .0884
Tax associated with business income	$1,149

In this example, the taxpayer can offset the tax with the hiring credit available up to $1,149.

Note: Net tax/tax and alternative minimum tax impose limitations on the allowable offset but were not considered a factor in this example.

2540 General Provisions – Apportionment of Business Income

References 17053.74(j)(2)&(3); 23622.7(j)(2)&(3)

If a business is located within and outside of an EZ or in more than one zone, the taxpayer must determine the portion of the business income that is attributable to each EZ.

- Business income is defined under the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA).
- Components of the factors are defined under the provisions of UDITPA.

For taxable years beginning on or after January 1, 1998, apportion business income to the EZ by multiplying the taxpayer's total California source business income by a fraction, the numerator of which is the property factor plus the payroll factor, and the denominator of which is two (2).

Note: For taxable years ending on or before December 31,1997, refer to Sections 5700-5715.

Example: For the taxable year ending 12/31/2004, Corporation A operates within and outside an EZ. California business income of $13,000 must be apportioned to the EZ. The following amounts apply to Corporation A's property and payroll:

EZ Property	$	40,000
CA Property	$	100,000
EZ Property/CAProperty		0.40
EZ Payroll	$	5,000
CA Payroll	$	10,000
EZ Paryoll/CA Payroll		0.50
Total EZ Factor (Property + Payroll)		0.90
EZ Apportionment Factor (90% / 2)		0.45

Business Income	$	13,000
EZ Apportionment Factor		x 0.45
EZ Business Income	$	5,850
Current Tax Rate		x .0884
Tax Attributable to EZ	$	517

Example: For the taxable year ending 12/31/2004, Corporation B operates in multiple locations, and in two EZs. California business income of $200,000 must be apportioned to each of the EZs. The following amounts apply to Corporation B's property and payroll:

	EZ 1	EZ 2
EZ Property	$ 40,000	$ 20,000
CA Property	$100,000	$ 100,000
EZ Property/CA Property	0.40	0.20
EZ Payroll	$ 5,000	$ 3,000
CA Payroll	$ 10,000	$ 10,000
EZ Payroll/CA Payroll	0.50	0.30
Total EZ Factor (Property + Payroll)	0.90	0.50
EZ Apportionment Factor / 2	0.45	0.25
CA Business Income	200,000	200,000
EZ Apportionment Factor	0.45	0.25
EZ Income (Business Income x EZ Factor)	$ 90,000	$ 50,000
Current Tax Rate	x .0884	x .0884
Tax Attributable To Each EZ	$ 7,956	$ 4,420

2541 Property Factor – Income Apportionment

The property factor is a fraction. The numerator of the property factor is the average value of the real and tangible personal property owned or rented and used or available for use by the taxpayer within the EZ during the taxable year.

The denominator is the average value of all real and tangible personal property owned or rented and used or available for use by the taxpayer during the taxable year within California.

Rented property is valued at eight (8) times the net annual rental rate. The net annual rental rate is the total rent paid for the property, less any sub rental rates paid by subtenants.

2542 Payroll Factor – Income Apportionment

The payroll factor is a fraction. The numerator of the payroll factor is the total compensation paid to the taxpayer's employees working within the EZ during the taxable year.

The denominator is the total compensation paid to employees working for the taxpayer in California during the taxable year.

2544 Apportionment – Combined Groups

For members of a combined group, the limitation is based on the intrastate apportioned business income for each taxpayer doing business within the EZ. The numerator of the apportionment formula is based on each EZ taxpayer's separate (EZ) property and payroll amounts and the denominator is based on each (EZ) taxpayer's separate California property and payroll amounts.

Example: For the taxable year ending 12/31/2004, parent corporation A has two subsidiaries, B and C. Corporations A and B operate within the EZ. The combined group operates within and outside California and apportions its income to California using Schedule R. Assume the combined group's business income apportioned to California was $1,000,000 and corporation A and B's share of California business income is $228,000 and $250,000 respectively. Corporation A and B's separate EZ and separate California property and payroll factor amounts are shown below.

Business income apportioned to the EZ was determined as follows:

	A	B
Property Factor		
EZ Property	$1,000,000	$ 800,000
California Property	$1,000,000	$1,200,000
Apportionment %	100%	66.66%
Payroll Factor		
EZ Payroll	$800,000	$ 800,000
California Payroll	$800,000	$1,000,000
Apportionment %	100%	80%
Average Apport. % (Property + Payroll Factors)/2	100%	73.33%

Apportioned		
Business Income	$228,000	$250,000
EZ Income	$228,000	$183,333

Note: Corporations operating in multiple EZs must compute the business income activity limitation for each EZ (see example Section 2540)

2545 Apportioning for Personal Income Tax Taxpayers

The following examples show the application of the apportioning rules to personal income tax taxpayers.

Example: Ray Smith is vice president of an S corporation that has two locations, one within an EZ and one outside the EZ. Eighty percent (80%) of the S corporation's business is attributable to the EZ.

Note: This percentage was determined by the S corporation, using Worksheet V from the FTB 3805Z Business Booklet, at the time the S corporation return was prepared). Ray divides his time equally (50% & 50%) between the two offices of the S corporation.

Mary Smith (Ray's spouse) works for the S corporation at its office located in the EZ.

Ray and Mary Smith have the following 2004 items of California income and expense:

Ray's salary from the S corp.	$100,000
Mary's salary from the S corp.	75,000
Interest on savings account	1,000
Dividends	3,000
Schedule K-1(100S) from the S corp.	
Ordinary income	40,000
EZ business expense deduction	(5,000)*
Ray's unreimbursed employee expenses from Schedule A	(2,000)

*The EZ business expense deduction is a separately stated item on Schedule K-1 (100S).

The Smith's EZ income is computed as follows:

Ray's EZ salary ($100,000 x 50%)	$50,000
Mary's EZ salary ($75,000 x 100%)	75,000
Pass-through ordinary income from the S-Corp. ($40,000 x 80%)	32,000
EZ business expense deduction from the S-Corp.	(5,000)
Ray's unreimbursed employee business expenses (2,000 x 50%)	(1,000)
Total EZ income	$151,000

Ray and Mary must compute the tax on the total EZ income of $151,000 (as if it represents all of their income). Using the tax rate schedule for the filing status married filing joint; the 2004 tax on $151,000 is $10,091. The $10,091 is the first limitation on EZ credits for the 2004 tax year. The second limitation on the credits is the net tax on all income.

Note: The standard deduction and personal or dependency exemptions are not included in the computation of EZ income since they are not related to trade or business activities.

2550 S Corporations

References 23803(a)(1)(A); 23803(a)(1)(F)

An S corporation's hiring credit may reduce the EZ tax at both the corporate and shareholder levels. However, the S corporation may only use one-third (1/3) of the credit to reduce the tax on the S corporation's EZ income.

One hundred percent (100%) of the EZ credit is passed through to the S corporation shareholders. The full amount of the credit is reported on Schedule K (100S) and passed through to the shareholders on Schedules K-1 (100S).

The wage reduction for the S corporation is equivalent to the 1/3 credit amount. The wage reduction for the shareholders is 100% of the credit amount, equal to the amount of credit passing through to them.

Example: An S corporation computes a $3,000 hiring credit. The S corporation's credit is $1,000 and the wage reduction is $1,000. The $3,000 credit is passed through to the S corporation's shareholders, and the wage reduction recognized by the shareholders is $3,000.

2600 CREDIT USAGE & CARRYOVER

References 17039(d); 17053.74(i); 17053.74(j)(1); 17053.74(j)(4); 23036(f); 23622.7(i); 23622.7(j)(1); 23622.7(j)(4)

The total amount of the EZ hiring credit and sales or use tax credit, including any credit carryover from prior years that may reduce the net tax/tax for the taxable year, shall not exceed the amount of tax imposed on the taxpayer's business income attributable to the EZ, determined as if that income represented all of the income of the taxpayer.

The portion of the credit that exceeds the net tax/tax for the taxable year may be carried over and added to the credit, if any, in the following year. The credit may be carried over to succeeding years until it is exhausted.

If a credit carryover remains after the EZ has expired, is no longer binding, or becomes inoperative, the EZ shall be deemed to remain in existence for purposes of computing the taxpayer's business income attributable to the EZ.

Example: A taxpayer has a $4,900 EZ hiring credit. Tax imposed on EZ business income is $4,700 and the taxpayer's overall net tax/tax is $4,000. The taxpayer would be eligible to claim a $4,000 maximum hiring credit.

Total hiring credit	$4,900
Tax on EZ income	$4,700
First limitation:	
Lesser of total credit or tax on EZ income	$4,700
Second limitation:	
Lesser of tax on EZ income or "net tax"/"tax"	$4,000
Maximum credit allowed:	
Lesser of EZ tax limitation or "net tax"/"tax" limitation	$4,000
Total hiring credit	$4,900
Maximum credit allowed	$4,000
Carryover	$ 900

2610 Credit Will Not Reduce Certain Taxes

The EZ hiring credit cannot reduce the:

- Minimum franchise tax (corporations, limited partnerships, limited liability partnerships, LLCs, and S corporations).
- Built-in gains tax (S corporations).
- Excess net passive income tax (S corporation).
- The annual tax (partnerships, LLCs classified as partnerships, and Q Subs).
- Alternative minimum tax (corporations, exempt organizations, individuals and fiduciaries).

The EZ hiring credit can reduce the regular tax below tentative minimum tax (TMT) for taxable years beginning on or after January 1, 1993.

2620 Credit Recapture

References 17053.74(e)(1); 17053.74(e)(3); 23622.7(e)(1); 23622.7(e)(3)

2621 Non-Seasonal Employees

Recapture of the hiring credit is required if the employee is terminated before the end of the longer of the following two periods (unless an exception is met):

- The first 270 days of employment (whether or not consecutive).
- Ninety (90) days of employment plus 270 calendar days.

To recapture the credit the taxpayer must add to the current year's tax the amount of credit claimed for the year of termination, as well as all prior year credit claimed for the terminated employee.

2622 Seasonal Employees

For taxable years beginning on or after January 1, 1998, for seasonal employees, the taxpayer must recapture the amount of the credit if employment is terminated before the completion of 270 days of employment" during the 60-month period beginning the day the employee commences employment with the taxpayer except as subsequently discussed.

To recapture the credit the taxpayer must add the amount of credit previously claimed in all years to the tax for the tax year that includes the 60th month of employment.

For all employees, a day of employment includes any day the employee was paid to work, regardless of whether the employee actually worked (including paid holidays, sick days, and vacation days).

Note: Any increase in tax due to credit recapture cannot be offset by the current year hiring credit.

2623 Credit Recapture – Exceptions

References 17053.74(e)(2)(A); 17053.74(e)(2)(B); 23622.7(e)(2)(A); 23622.7(e)(2)(B)

For both regular and seasonal employees, the credit recapture will not apply if the termination was:

- Voluntary on the part of the employee.
- Caused by the employee becoming disabled.
- Due to employee misconduct.
- Due to a substantial reduction in business.
- In order to enable other qualified employees to be hired, creating an increase in the number of qualified employees and the hours of employment.

2624 Change in the Form of the Trade or Business

References 17053.74(e)(2)(C); 23622.7(e)(2)(C)

The employment relationship between the taxpayer and an employee shall not be treated as terminated by reason of a mere change in the form of conducting the trade or business. If the employee continues employment in that trade or business and the taxpayer retains a substantial interest in that trade or business, the employee shall not be treated as terminated. In addition, transactions in which IRC § 381(a) applies will not trigger recapture if the employee continues employment by the acquiring corporation.

2700 ENTERPRISE ZONE EXPIRATION

A large number of EZs expired in 2006 and 2007 (refer to Section 1200 for a complete listing of expired EZs). The EZ Hiring Credit is allowed for a full five-year period of employment from the date of hire for those qualified employees hired on or before the expiration date (regardless of the ending date of a taxpayer's taxable year). Wages paid to such employees after the expiration of the EZ will continue to qualify for the hiring credit as if the EZ designation were still in existence and binding (CR&TC § 17053.74(b)(1)(C); § 23622.7(b)(1)(C))

Credits incurred prior to the expiration of the EZ and subject to carryover will continue to be allowed after the expiration of the EZ. The limitation on use of the credit (limited to tax on income attributed to the zone, as if the zone were still in existence) will also remain in effect.

2800 RECORD KEEPING REQUIREMENTS

For each qualified employee, documentation showing:

- Voucher
- Employee name
- Date employee was hired
- Number of hours the employee worked for each month of employment
- Wage rate paid for each month of employment
- Schedule calculating the hiring credit
- Overtime hours
- Location where services were performed
- Date employee was terminated, and reason why

3000 ENTERPRISE ZONE SALES OR USE TAX CREDIT

References 17053.70(a); 17053.70(b); 23612.2(a); 23612.2(b)

A taxpayer engaged in a trade or business within a designated Enterprise Zone (EZ) can take a credit for sales or use tax paid or incurred in connection with the purchase of qualified property.

- In any year, individuals and partnerships may claim a credit equal to the sales or use tax paid or incurred on the purchase of qualified property not to exceed $1 million.
- In any year, corporations may claim a credit equal to the sales or use tax paid or incurred on the purchase of qualified property not to exceed $20 million (see special rule for S corporations and shareholders in Section 3600).

No credit may be claimed for property purchased after the EZ designation expires, is no longer binding, or becomes inoperative.

3100 GEOGRAPHIC BOUNDARIES AND DESIGNATION DATES

For a listing of EZs and designation dates, refer to Section 1310. To verify an address, refer to Section 1300.

3110 Enterprise Zone Expiration

A large number of EZs expired in 2006 and 2007 (refer to Section 1200 for a complete listing of expired EZs). The sales or use tax credit is allowed for qualified property purchased and placed in service up to the expiration date (regardless of the ending date of a taxpayer's taxable year). Credits incurred prior to the expiration of the EZ and subject to carryover will continue to be allowed after the expiration of the EZ. The limitation on the use of the credit (limited to tax on income attributed to the zone) will also remain in effect.

3200 MULTIPLE CREDITS ALLOWED

Property that qualifies for the EZ sales or use tax credit may also qualify for the Manufacturers' Investment Credit (expired effective January 1, 2004). The taxpayer is allowed to take both credits on the same property.

Example: Taxpayer A purchases an asset for $100,000 and pays $8,000 in sales tax (8% sales tax rate). The asset is qualified property under both the EZ sales or use tax credit and the Manufacturers' Investment Credit provisions. Assuming all other relevant criteria are met to claim both credits:

- The EZ sales or use tax credit is $8,000 (amount of sales or use tax paid).
- The Manufacturers' Investment Credit is $6,000 ($100,000 x 6%).

3300 QUALIFIED TAXPAYER

References 17053.70(b)(1); 23612.2(b)(1)

A qualified taxpayer is a person or entity engaged in a trade or business within an EZ.

3310 Pass-Through Entities

The determination of whether a taxpayer is a qualified taxpayer is made at the entity level. The term pass-through entity means any partnership or S corporation. The sales or use tax credit is allowed to the pass-through entity and passed through to the partners or shareholders.

3400 QUALIFIED PROPERTY

References 17053.70(b)(2); 23612.2(b)(2)

Qualified property must be used exclusively in the EZ and is defined as machinery and machinery parts used for:

- Fabricating, processing, assembling, and manufacturing.
- The production of renewable energy resources.
- Air pollution control mechanisms.
- Water pollution control mechanisms.

For taxable years beginning on or after January 1, 1998, qualified property also includes:

- Data processing and communications equipment, such as computers, computer-automated drafting systems, copy machines, telephone systems, and fax machines.
- Motion picture manufacturing equipment central to production and post-production, such as cameras, audio recorders, and digital image and sound processing equipment.

Generally, qualified machinery parts include those parts that are necessary for the operation of the machinery (e.g., a conveyor belt).

Property whose nature is intrinsically mobile or portable must be closely evaluated to verify that that it is used *exclusively* within an enterprise zone. Such property might include vehicles, laptop computers, or other similar assets.

3410 Capitalized Requirement

References 17053.70(b)(2); 17053.70(e); 23612.2(b)(2); 23612.2(e)

Qualified property must be purchased and placed in service before the EZ expires, is no longer binding, or becomes inoperative. Qualified property costs are costs chargeable to a capital account (subject to depreciation) of the qualified taxpayer. If costs are expensed rather than capitalized, no credit is allowed.

3420 Leased Property

Taxpayers who acquire property by lease arrangement may qualify for the sales or use tax credit. Lease arrangements structured using a financial (conditional sales) contract generally will qualify the taxpayer to take the sales or use tax credit. For reference sources to determine if a lease qualifies as a purchase rather than a lease arrangement, refer to IRS Revenue Ruling 55-540, 1955-2 C.B. 39, and FTB Legal Ruling 94-2, March 23, 1994.

3425 Credit Addback to Income

Unlike the hiring credit, an addback of the credit is not required. Some earlier tax forms may have been incorrect.

3500 CREDIT COMPUTATION – ASSET VALUE LIMITATION

References 17053.70(a); 17053.70(b)(2); 23612.2(a); 23612.2(b)(2)

The sales or use tax credit is equal to the amount of sales or use tax paid or incurred by the taxpayer in connection with the purchase and use of qualified property.

Example: Taxpayer spent $53,750 to purchase property used in the taxpayer's business within the EZ. The sales tax paid on the purchase is $3,750. The sales tax credit is $3,750.

Individuals, estates or trusts, partnerships, and limited liability companies (LLCs) taxed as partnerships may claim a credit on the sales or use tax paid or incurred to purchase up to $1 million of qualified property. Corporations may claim a credit on the sales or use tax paid or incurred to purchase up to $20 million of qualified property. This limitation applies to each taxable year (see special rule for S corporations and shareholders in Section 3600).

Note: Upon acquisition, if the taxpayer/purchaser was exempt from paying sales tax on the property under the California Revenue & Taxation Code (CR&TC), then the taxpayer/purchaser did not pay or incur sales tax in connection with the purchase of the property to the extent of the exemption. Thus, the taxpayer/purchaser is not allowed to take the sales or use tax credit on the amount of the exemption.

3510 Use Tax Paid on Qualified Property

References 17053.70(c) 23612.2(c)

If a taxpayer operating within an EZ purchases property out of state and pays or incurs a use tax, the credit is allowed only if qualified property of a comparable quality and price is not timely available for purchase in this state.

3520 Depreciable Basis

References 17053.70(e); 23612.2(e)

Any taxpayer that elects to claim the sales or use tax credit, shall not increase the basis of the qualified property by the amount of the sales or use tax paid or incurred.

Example*:* Taxpayer spent $53,750 to purchase property used in the taxpayer's business within the EZ. The sales tax included in the purchase price was $3,750. The basis of the property is $50,000 ($53,750 less $3,750 sales tax).

3530 Business Income Activity Limitation

References 17053.70(f); 23612.2(f)

The amount of sales or use tax credit and the hiring credit claimed (see Section 2000), including any credit carryover from prior years, may not exceed the amount of tax on the taxpayer's EZ business income in any year. The EZ business income is that portion of the taxpayer's *California source* business income that is apportioned to the EZ. Non-business income or loss is not included in the calculation of business income from the EZ. Each taxpayer claiming the credit must compute the EZ business income and resulting tax.

Example: Corporation A operates exclusively within an EZ. In order to determine the amount of sales or use tax credit allowable, the business income and the tax on that business income must be determined. Corporation A has the following items of income and expense:

Income from business operations	$30,000
Interest from investment which is unrelated to business operations	$2,000
Business expenses	(17,000)
Net Taxable Income	$15,000

Corporation A's income attributed to business operations is:

Income from business operations	$30,000
Business expenses	(17,000)
Net Business Income	$13,000

To determine the sales or use tax credit allowable, the net business income is multiplied by the current tax rate.

Net Business Income	$13,000
x 8.84%	x .0884
Tax associated with business income	$1,149

In this example, the taxpayer can offset the tax with the sales or use tax credit available up to $1,149.

Note: Net tax/tax and alternative minimum tax impose limitations on the allowable offset but were not considered a factor in this example.

3540 General Provisions – Apportionment of Business Income

References 17053.70(f); 23612.2(f)

If a business is located within and outside of an EZ, or in more than one zone, the taxpayer must determine the portion of the total business income that is attributable to each EZ.

- Business income is defined under the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA).
- Components of the factors are defined under the provisions of UDITPA.

For taxable years beginning on or after January 1, 1998, business income shall be apportioned to the EZ by multiplying the taxpayer's total California source business income by a fraction, the numerator of which is the property factor plus the payroll factor, and the denominator of which is two (2).

Note: For taxable years ending on or before December 31, 1997, refer to Sections 5700-5715.

Example: For the taxable year ending 12/31/2004, Corporation A operates within and outside an EZ. California business income of $13,000 must be apportioned to the EZ. The following amounts apply to Corporation A's property and payroll:

EZ Property	$	40,000
CA Property	$	100,000
EZ Property/CAProperty		0.40
EZ Payroll	$	5,000
CA Payroll	$	10,000
EZ Paryoll/CA Payroll		0.50
Total EZ Factor (Property + Payroll)		0.90
EZ Apportionment Factor (90% / 2)		0.45

Business Income	$	13,000
EZ Apportionment Factor		x 0.45
EZ Business Income	$	5,850
Current Tax Rate		x .0884
Tax Attributable to EZ	$	517

Example: For the taxable year ending 12/31/2004, Corporation B operates in multiple locations, and in two EZs. California business income of $200,000 must be apportioned to each of the EZs. The following amounts apply to Corporation B's property and payroll:

	EZ 1	EZ 2
EZ Property	$ 40,000	$ 20,000
CA Property	$100,000	$ 100,000
EZ Property/CA Property	0.40	0.20
EZ Payroll	$ 5,000	$ 3,000
CA Payroll	$ 10,000	$ 10,000
EZ Payroll/CA Payroll	0.50	0.30
Total EZ Factor (Property + Payroll)	0.90	0.50
EZ Apportionment Factor / 2	0.45	0.25
CA Business Income	200,000	200,000
EZ Apportionment Factor	0.45	0.25
EZ Income (Business Income x EZ Factor)	$ 90,000	$ 50,000
Current Tax Rate	x .0884	x .0884
Tax Attributable To Each EZ	$ 7,956	$ 4,420

3541 Property Factor – Income Apportionment

The property factor is a fraction. The numerator of the property factor is the average value of the real and tangible personal property owned or rented and used or available for use by the taxpayer *within the EZ d*uring the taxable year.

The denominator is the average value of all real and tangible personal property owned or rented and used or available for use by the taxpayer during the taxable year *within California*.

Rented property is valued at eight (8) times the net annual rental rate. The net annual rental rate is the total rent paid for the property, less any sub rental rates paid by subtenants.

3542 Payroll Factor – Income Apportionment

The payroll factor is a fraction. The numerator of the payroll factor is the total compensation paid to the taxpayer's employees working within the EZ during the taxable year.

The denominator is the total compensation paid to employees working for the taxpayer *in California* during the taxable year.

3544 Apportionment – Combined Groups

For members of a combined group, the limitation is based on the intrastate apportioned business income for each taxpayer doing business within the EZ. The numerator of the apportionment formula is based on each EZ taxpayer's separate EZ property and payroll amounts. The denominator is based on each EZ taxpayer's separate California property and payroll amounts.

Note: For taxable years ending on or before December 31, 1997, refer to Sections 5700-5715.

Example: For the taxable year ending 12/31/2004, parent corporation A has two subsidiaries, B and C. Corporations A and B operate within the EZ. The combined group operates within and outside California and apportions its income to California using Schedule R. Assume the combined group's business income apportioned to California was $1,000,000 and corporation A and B's share of California business income is $228,000 and $250,000 respectively. Corporation A and B's separate EZ and separate California property and payroll factor amounts are shown below.

Business income apportioned to the EZ was determined as follows:

	A	B
Property Factor		
EZ Property	$1,000,000	$ 800,000
California Property	$1,000,000	$1,200,000
Apportionment %	100%	66.66%
Payroll Factor		
EZ Payroll	$800,000	$ 800,000
California Payroll	$800,000	$1,000,000
Apportionment %	100%	80%

Average Apport. % (Property + Payroll Factors)/2	100%	73.33%
Apportioned Business Income	$228,000	$250,000
EZ Income	$228,000	$183,333

Note: Corporations operating in multiple EZs must compute the business income activity limitation for each EZ (see example Section 3540)

3545 Apportioning for Personal Income Tax Taxpayers

The following examples show the application of the apportioning rules to personal income tax taxpayers.

Example: Ray Smith is vice president of an S corporation that has two locations, one within an EZ and one outside the EZ. Eighty percent (80%) of the S corporation's business is attributable to the EZ (determined by the S corporation using Worksheet V from the FTB 3805Z Business Booklet at the time the S corporation return was prepared). Ray divides his time equally (50% & 50%) between the two offices of the S corporation.

Mary Smith (Ray's spouse) works for the S corporation at its office located in the EZ.

Ray and Mary Smith have the following 2004 items of California income and expense:

Ray's salary from the S corp.	$100,000
Mary's salary from the S corp.	75,000
Interest on savings account	1,000
Dividends	3,000
Schedule K-1(100S) from the S corp.	
Ordinary income	40,000
EZ business expense deduction	(5,000)*
Ray's unreimbursed employee expenses from Schedule A	(2,000)

*The EZ business expense deduction is a separately stated item on Schedule K-1 (100S).

The Smith's EZ income is computed as follows:

Ray's EZ salary ($100,000 x 50%)	$50,000
Mary's EZ salary ($75,000 x 100%)	75,000
Pass-through ordinary income from the S-Corp. ($40,000 x 80%)	32,000
EZ business expense deduction from the S-Corp.	(5,000)
Ray's unreimbursed employee business expenses (2,000 x 50%)	(1,000)
Total EZ income	$151,000

Ray and Mary must compute the tax on the total EZ income of $151,000 (as if it represents all of their income). Using the tax rate schedule for the filing status married filing joint, the 2004 tax on $151,000 is $10,091. The $10,091 is the first limitation on EZ credits for the 2004 tax year. The second limitation on the credits is the net tax on all income.

Note: The standard deduction and personal or dependency exemptions are not included in the computation of EZ income since they are not related to trade or business activities.

3600 S CORPORATION & SHAREHOLDER CREDIT AMOUNTS

REFERENCES 17053.70(B)(2)(B); 23612.2(B)(2)(B); 23803

S corporations operating within an EZ may claim a credit on the sales or use tax paid or incurred to purchase up to $20 million of qualified property. This limitation applies to each taxable year. The S corporation may only use one-third (1/3) of the credit to reduce the tax on the S corporation's EZ income.

An S corporation's sales or use tax credit may reduce the EZ tax at both the corporate and shareholder levels. One hundred percent (100%) of the EZ credits are passed through to the S corporation shareholders. However, S corporation individual shareholders are only allowed to claim a credit on the sales or use tax paid or incurred on the purchase of up to $1 million of qualified property of the S corporation for each taxable year.

The sales or use tax credit is first computed for the S corporation using the actual qualified acquisition costs not to exceed $20 million. The amount of credit passing through to the shareholders is then computed using the actual qualified acquisition costs not to exceed $1 million. This credit based on the $1 million limitation is passed through to the individual shareholders based on their pro rata share. The Schedules K (100S) and K-1 (100S) must state the credit amounts allocable to the shareholders.

Example: Corp. Z, an S corporation, purchases $2 million of qualified property, and takes the EZ sales or use tax credit. Corp. Z is allowed to claim a sales or use tax credit of $50,000 ($2,000,000 x 7.5% x 1/3 = $50,000). [Cost (not to exceed $20,000,000) x sales tax rate x 1/3 S corporation credit limitation]

The corporation's two shareholders allocate between them a sales or use tax credit of $75,000 ($1,000,000 x 7.5% = $75,000). [Cost (not to exceed $1,000,000) x sales tax rate].

Note: The State Board of Equalization in an unpublished (non-citable) decision concluded that the $20 million limitation applied to the S-Corp level income tax credit and the $1 million limitation applied collectively to calculating the share of credit for each of the S-Corp shareholders. *Appeal of Barry and Wendy Breslow,* Cal. St. Bd. Of Equal., November 6, 2001.

3700 SALES OR USE TAX CREDIT AND THE HIRING CREDIT

References 17053.70(f)(1); 23612.2(f)(1)

The amount of credit allowed in any taxable year, when a taxpayer is eligible to take both the sales or use tax credit and the hiring credit, is limited to the amount of tax imposed on the EZ income. Thus, the taxpayer must aggregate the credits and limit the total amount of credits to tax imposed on the EZ income.

3800 CREDIT USAGE AND CARRYOVER

References 17053.70(d); 17053.70(f); 23612.2(d); 23612.2(f)

The portion of the credit that exceeds the net tax/tax for the taxable year may be carried over and added to the credit, if any, in the following year. The credit may be carried over to succeeding years until it is exhausted.

The aggregate amount of EZ credits, including any credit carryover from prior years, that may reduce the net tax/tax for the taxable year shall not exceed the amount of tax imposed on the taxpayer's business income attributable to the EZ, determined as if that income represented all of the income of the taxpayer.

Example: A taxpayer has $4,900 in EZ credits (sales or use tax credit and hiring credit). Tax imposed on EZ business income is $4,700 and the taxpayer's overall net tax/tax is $4,000. The maximum amount of credit is limited to the lesser of the tax on the EZ business income, or the tax on the taxpayer's overall net tax/tax.

Total EZ credit	$4,900
Tax on EZ income	$4,700
First limitation:	
Lesser of total credit or tax on EZ income	$4,700
Second limitation:	
Lesser of tax on EZ income or "net tax"/"tax"	$4,000
Maximum credit allowed:	
Lesser of EZ tax limitation or "net tax"/"tax" limitation	$4,000
Total EZ credit	$4,900
Maximum credit allowed	$4,000
Carryover	$ 900

In the event that a credit carryover is allowable for any taxable year after the EZ designation has expired, the EZ will be deemed to remain in existence for the purpose of computing the business income limitation.

3810 Credit Will Not Reduce Certain Taxes

The EZ sales or use tax credit cannot reduce the:

- Minimum franchise tax (corporations, limited partnerships, limited liability partnerships, LLCs, and S corporations),
- Built-in gains tax (S corporations),
- Excess net passive income tax (S corporation),
- The annual tax (partnerships, LLCs classified as partnerships, and Q Subs),
- Alternative minimum tax (corporations, exempt organizations, individuals, and fiduciaries).

However, the EZ sales or use tax credit may reduce regular tax below tentative minimum tax.

3820 Depreciation

REFERENCES 17053.70(E); 17267.2(F); 18036; 23612.2(E); 24356.7(E); 24916

Taxpayers electing to utilize the sales or use tax credit are not entitled to increase the basis of the property for which sales or use tax was paid or incurred in connection with the purchase of the property.

Depreciation of the capitalized cost of the asset may be claimed using any method of depreciation allowable beginning in the year the asset is placed in service.

3830 Credit Recapture

There are no recapture provisions for the EZ sales or use tax credit.

3900 RECORD KEEPING REQUIREMENTS

To support the sales or use tax credit claimed, the taxpayer must keep all records that document the purchase of the qualified property and payment of sales or use tax. This includes items such as purchase receipts and proof of payment. In addition, taxpayers should keep all records that identify or describe:

- The property purchased (such as serial numbers, etc.).
- The amount of sales or use tax paid or incurred upon purchase.
- The location where the property is used.
- Sales or use tax returns filed with the Board of Equalization.
- Audit reports issued by the Board of Equalization for audits related to use tax paid, or fixed asset audits.
- If purchased from a manufacturer located outside California, records to substantiate that property of comparable quality and price was not available for purchase in California.

4000 ENTERPRISE ZONE BUSINESS EXPENSE DEDUCTION

References 17267.2(a); 17267.2(c); 24356.7(a); 24356.7(b)

For each taxable year, a taxpayer engaged in a trade or business within an Enterprise Zone (EZ) may elect to treat 40% of the eligible cost of qualified property as a business expense rather than a capital expense.

The deduction is allowed for the taxable year in which the property is placed in service.

Taxpayers must make an election to treat the cost of qualified property as a business expense on the original return filed for the taxable year the property is first placed in service. The election must specify the items to which the election applies and the portion of the cost taken into account for purposes of determining the deduction amount.

The election may not be revoked unless the taxpayer has obtained the consent of the Franchise Tax Board.

Note: A large number of EZs expired in 2006 and 2007 (refer to EDAM 1200 for a complete listing of expired EZs). The business expense deduction for businesses operating in an expired EZ is allowed for qualified property purchased and placed in service up to date of expiration (regardless of the ending date of a taxpayer's taxable year).

4100 GEOGRAPHIC BOUNDARIES AND DESIGNATION DATES

For a listing of EZs and designation dates, refer to Section 1310. To verify an address, refer to Section 1300.

4200 QUALIFIED TAXPAYER

References 17267.2(e); 24356.7(d)

A qualified taxpayer is a person or entity that conducts a trade or business within an EZ.

4210 Estates and Trusts

References 17267.2(d)(4)

Estates and trusts are not allowed to take the business expense deduction.

4220 Pass-Through Entities

The determination of whether a taxpayer is a qualified taxpayer is made at the entity level. The term pass-through entity means any partnership or S corporation. The business expense deduction is allowed to the pass-through entity and passed through to the partners or shareholders.

4300 QUALIFIED PROPERTY

References 17267.2(d)(1); 24356.7(c)(1)

Qualified property is IRC § 1245 property (as defined in section 1245(a)(3) of the Internal Revenue Code) purchased and placed in service for *exclusive use* in a trade or business conducted within an EZ. The property must also be purchased and placed in service *before* the date the EZ designation expires, is no longer binding, or becomes inoperative.

Qualified property under IRC § 1245 includes, but is not limited to, tangible personal property (excluding buildings and inventory) that is subject to the allowance for depreciation. This includes most equipment and furnishings purchased for *exclusive use* within the EZ. Office supplies and other small non-depreciable items are not included.

4310 Leased Property

Taxpayers who acquire property by lease arrangement may be able to take the business expense deduction. The structure of the leasing arrangement itself is critical. Lease arrangements structured using a financial (conditional sales) contract generally will qualify the taxpayer to take the business expense deduction. For reference sources to determine if a lease qualifies as a purchase rather than a lease arrangement, refer to IRS Revenue Ruling 55-540, 1955-2 C.B. 39, and FTB Legal Ruling 94-2, March 23, 1994.

4320 Property Not Qualified

References 17267.2(d); 24356.7(c)

The business expense deduction is not allowed if the property:

- Was transferred between members of an affiliated group.
- Was acquired as a gift or inherited.
- Was traded for other property.
- Was received from a personal or business relation as defined by IRC § 267, as modified by 17267.2(d)(2)(A).
- Was received from a personal or business relation as defined by California Revenue & Taxation Code Sections 24427 through 24429, as modified by 24356.7(c)(2)(A).
- Was received from a personal or business relation as defined by IRC § 707(b).
- Is described in IRC § 168(f).
- Was placed in service prior to EZ Designation.
- Was placed in service after the EZ Expired.

4400 DEDUCTION AMOUNT

References 17267.2(g); 24356.7(f)

The aggregate deduction the taxpayer may claim in any taxable year is determined by the number of years that have elapsed since the zone was designated, as follows:

Taxable Years	**Maximum Aggregate Cost**	**Maximum Aggregate Deduction**
Taxable year of designation and 1st year thereafter	$100,000	$40,000
2nd and 3rd taxable year thereafter	$75,000	$30,000
Each taxable year thereafter	$50,000	$20,000

4410 Pass-Through Entities

References 17267.2(d)(6)

In the case of pass-through entities, the percentage limitation (40%) of the aggregate cost of all qualified property, shall apply at the entity level and at the partner/shareholder level.

4420 Personal Income Tax Taxpayers-Married Filing Separate

References 17267.2(b)

In the case of a husband and wife filing separate returns for a taxable year, the applicable deduction is equal to one-half (50%) of the otherwise allowable deduction.

4430 Basis Reduction / Depreciation

The basis (cost for depreciation purposes) of the property must be reduced by the amount allowed as a deduction. Normal depreciation is allowed on the cost of the property in excess of the expensed amount. The taxpayer may use any method that is allowable for California purposes, beginning with the taxable year following the year in which the property is placed in service.

Taxpayers electing to take the business expense deduction cannot claim the additional first year depreciation allowed under IRC § 179 / CR&TC §24356 for any property.

Example: Corporation A (a calendar year taxpayer) purchases a piece of equipment for $10,000 and places it into service on January 1, 2002. For tax year 2002, the business expense deduction is $4,000 and $6,000 remains to be depreciated. If the property has a 5-year useful life, the taxpayer will deduct depreciation of $1,500 ($6,000/4) for the remaining 4 years (taxable years 2003-2006).

4440 Interaction With The Manufacturers' Investment Credit

References 17053.49(b)(1)(C); 23649(b)(1)(C)

Taxpayers claiming the business expense deduction and the Manufacturers' Investment Credit (MIC) for the same property must reduce MIC qualified costs by the amount of the business expense deduction before computing the MIC. Taxpayers that elect to take the business expense deduction are not allowed to capitalize the expensed amount.

4450 Recapture

References Cal. Code Regs. (CCR) § 17267.2-1(a); 24356.7-1

The business expense deduction is subject to recapture (added back to income) if, before the close of the second taxable year after the property is placed in service, the property is sold, disposed of, or is no longer used exclusively within the EZ trade or business. The taxpayer is required to recapture the amount previously expensed for that item and shall include that amount as income for the taxable year in which the property ceases to be used. The basis of the property shall be increased as of the first day of the taxable year in which the recapture event occurs.

Example: Corporation A, a calendar year taxpayer, purchased property on June 1, 2002 that qualifies Corp. A to take the EZ business expense deduction. Corp. A disposes of the property August 5, 2004. The previous deduction is added to income in the 2004 tax year because the property was disposed of before the close of the second taxable year after the property was placed in service, 12/31/2004. The basis in the asset would be increased by the recaptured amount effective January 1, 2004.

Note: The State Board of Equalization in an unpublished (non citable) decision held that the statute requires the closure of two taxable years after the end of the taxable year in which the property is placed in service and the election to claim the deduction on the original return is made. *Appeal of Accurate Metal Fabricators, Inc., 32552, Cal. St. Bd. Of Equal., July 3, 2000.*

4500 MAKING THE ELECTION

A taxpayer makes an election by filing:

- Form FTB 3805Z - Enterprise Zone Deduction and Credit Summary

4510 Members of an Affiliated Group

References 24356.7(c)(5); 24356.7(c)(6)

For purposes of electing the business expense deduction, all members of an affiliated group are treated as one taxpayer. The maximum deduction amount is properly apportioned among the members of the affiliated group.

An affiliated group is defined in IRC § 1504 as modified by the California Revenue & Taxation Code, to replace "at least 80%" with "more than 50%" each place it appears in IRC § 1504(a).

4600 CREATING A NET OPERATING LOSS

Unlike IRC § 179, there is no statutory prohibition on the amount of business expense deduction that may create a net operating loss.

4700 ALTERNATIVE MINIMUM TAX

References 17062; 23457

The business expense deduction is *not* listed as a tax preference item.

4800 CHECKLIST OF ELIGIBILITY FOR THE BUSINESS EXPENSE DEDUCTION

Checklist Items	Yes	No
Is the business qualified? • Is a trade or business conducted within an EZ? See the *Qualified Taxpayer* section.		
Is the property qualified? • Qualified property is Section 1245 property. See the *Qualified Property* section. • Is the property used exclusively within the boundaries of the EZ?		
Is the correct deduction amount claimed? • Limitation differs based on the taxable year since zone designation. See *Deduction Amount* section. • Verify purchase on invoices or receipts. • Verify the date the property is placed in service.		
Was a timely election made? • Election made on original return? • Form FTB 3805Z – Enterprise Zone Deduction and Credit Summary, or a separate statement attached to the return?		
Was the property acquired through a valid transaction? • See the Property Not Qualified section.		
Was correct depreciation claimed? • Basis must be reduced by the amount of the business expense deduction before depreciation is computed. • IRC § 179 expense or additional first year depreciation may not be claimed for qualified property for which the business expense deduction is claimed. • A depreciation deduction on qualified property is not allowed in the same year the business expense deduction is claimed.		
Is the deduction subject to recapture? • Was the property sold, disposed of or no longer used by the taxpayer in the zone, before the close of the second taxable year after the property was placed in service? • Check current location of the qualified property. • Check sale or disposal date of qualified property.		

4900 RECORD KEEPING REQUIREMENTS

To support the business expense deduction claimed, the taxpayer must keep all records that document the purchase of the qualified property. This includes items such as purchase receipts and proof of payment. In addition, taxpayers should keep all records that identify or describe:

- The property purchased (such as serial numbers, etc.).
- The location where the property is used.

5000 ENTERPRISE ZONE NET OPERATING LOSS (NOL)

References 17276; 17276.1(a); 17276.2; 17276.3
24416; 24416.1(a); 24416.2; 24416.3

Taxpayers are required to annually report their income and expenses. Due to possible fluctuations in income and expenses, a taxpayer may have substantial profits in one year, while losses in another. In years where expenses exceed income, an NOL occurs.

For entities conducting business within an Enterprise Zone (EZ), a qualified taxpayer may elect to carry forward 100% of its NOL for a 15-year period.

An EZ NOL cannot be generated until the first taxable year beginning on or after the area has been officially designated as an EZ.

Note: A large number of EZs expired in 2006 and 2007 (refer to EDAM 1200 for a complete listing of expired EZs). The EZ NOL is allowed for losses attributed to a taxpayer's trade or business activities within the EZ prior to the expiration date. To determine this loss, the loss is computed as if the taxpayer operated in the EZ for the entire year, then the loss is assigned to the EZ based on the number of days the taxpayer conducted business in the EZ (numerator) as compared to the number of days in the tax year (denominator).

Example: A calendar year taxpayer operating in the Eureka EZ, which expired 10/14/2006, incurred an NOL for the full taxable year of $100,000. Assume the taxpayer’s zone payroll and property factors were 80%, so the EZ NOL for the full taxable year would be equal to $80,000. The taxpayer's EZ NOL is $62,904 ($80,000 *287 /365 (January 1 to October 14 equals 287 days).

Net operating losses incurred prior to the expiration of an EZ and subject to carryover will continue to be allowed after the expiration of the EZ. The limitation on the use of the net operating loss (limited to income attributed to the zone) will also remain in effect.

5100 GEOGRAPHIC BOUNDARIES AND DESIGNATION DATES

For a listing of EZs and designation dates, refer to Section 1310. To verify an address, refer to Section 1300.

5200 QUALIFIED TAXPAYER

References 17276.2(a); 24416.2(a)

For purposes of the EZ NOL deduction, a qualified taxpayer includes a person or entity that is engaged in a trade or business within an EZ.

Taxpayers doing business in an area that was previously not a qualified area, but is later designated as qualified, are allowed to elect the NOL for the taxable year beginning on or after the date the area received its designation as an EZ.

5210 Pass-Through Entities

References 17087.5; 17087.6; 17851; 23800; 24271

In the case of any pass-through entity, the determination of whether a taxpayer is a qualified taxpayer is made at the entity level.

The income and loss that will flow through to a shareholder, beneficiary, partner, or member retains the same characteristics as it had with the pass-through entity.

The election (see Section 5300) to claim an NOL is made by the entity *and* each investor on their respective returns. The election by the entity to utilize the EZ NOL does not extend to, or bind the investor to utilize the EZ NOL. Further, the investor may utilize the EZ NOL if the entity utilized the general NOL provisions, or had no NOL. Each taxpayer must determine if they in fact have a NOL, and then decide whether the general or EZ NOL will be utilized.

5211 S Corporations

References 23802(d)(1)-(2)

For qualified taxpayers electing S corporation status *after* the designation of the EZ, the qualified NOL attributed to the C corporation years cannot offset S corporation net income.

5300 MAKING THE ELECTION

References 17276.1(a)-(b); 17276.2(b)-(d); 24416.1(a) & (c); 24416.2(b)-(d)

Qualified taxpayers must make an election to claim the EZ NOL. The election must be timely filed with the original return, and be for the taxable year in which the NOL is incurred. The election is irrevocable.

If the taxpayer is eligible to qualify for an NOL under more than one section (operating in more than one economic development area, new small business etc.), the taxpayer must choose which section to elect. Except for the loss incurred under the subdivision elected, taxpayers are prohibited from carrying over any other type of NOL from the same tax year.

Failure to elect to compute the NOL deduction under CR&TC §17276.1 or 24416.1 will cause the NOL to be subject to the limitations and restrictions under CR&TC §17276 or 24416 (general NOL).

A taxpayer makes the election by filing Form FTB 3805Z – Enterprise Zone Deduction and Credit Summary.

In addition, the form FTB 3805Z must be filed for each year in which the NOL deduction is taken.

5400 EZ NOL COMPUTATION - GENERAL PROVISIONS

References 17276.1(a); 17276.2(a)(2)(A); 24416.1(a); 24416.2(a)(2)(A)

An EZ NOL is the loss attributable to the qualified taxpayer's business activities within an EZ prior to the EZ expiration date. EZ NOLs are determined under IRC § 172, as modified by the following CR&TC sections:

- 17276.1
- 17276.2
- 24416.1
- 24416.2

5410 EZ NOL Limited by General NOL

References 17276; 24416

The EZ NOL is compared to the NOL computed under the general NOL provisions of the CR&TC § 17276 / 24416 *prior to any reduction per R&TC 17276/24416(1)(A)-(D)*. The EZ NOL carryover is limited to the lesser of the EZ NOL or the general NOL (prior to any reduction).

Note: If the EZ NOL is limited by the general NOL amount, (prior to any reduction), the amount can still be characterized as an EZ NOL and allowed to be carried over at 100% for 15 years. An election must be made to characterize the NOL as an EZ NOL.

Example: Corp. B incurred the following loss in tax year 2003:

Income from business operations	$160,000
Interest from investment which is unrelated to Corp. B's business operations	15,000
Expenses of business operations	(189,000)
Net loss	($14,000)

To determine the NOL carryover attributed to the EZ business operations, the following must be done:

1. Determine NOL per CR&TC §24416 (prior to any reduction)
2. Determine NOL per CR&TC §24416.2

The NOL carryover is limited to the lesser of the general NOL (item 1) or the EZ NOL (item 2) above.

1. CR&TC §24416 general NOL - prior to 40% reduction

Net loss of Corp. B	($14,000)

2. CR&TC §24416.2 EZ NOL - exclude non-business income/loss

Income from operations	$160,000
Expenses of operations	(189,000)
Net loss of Corp. B (EZ)	($29,000)

Pattern 1: Assume Corp. B operates entirely within the EZ. Corp. B is allowed to carry over the lesser of the general NOL or the EZ NOL; in this case the general NOL of $14,000.

Pattern 2: Assume Corp. B conducts 35% of its total business operations in the EZ. Because Corp. B only has 35% of its business operation in the EZ, the $29,000 business loss must be apportioned before comparing it to the general NOL. In this example, the EZ loss is $10,150 ($29,000 x 35%). Corp. B is allowed to carry over the lesser of the general NOL or the EZ NOL; in this case the EZ NOL of $10,150.

5500 EZ NOL - LOSS ATTRIBUTED TO BUSINESS ACTIVITY

References 17276.2(a)(2)(A) - (B); 24416.2(a)(2)(A) - (B)

An EZ NOL is the loss attributable to the qualified taxpayer's business activities within the EZ prior to the EZ expiration date. Non-business income and/or loss are excluded from the calculation of the EZ NOL.

If a business is located within and outside of an EZ, or in more than one EZ, the taxpayer must determine the portion of the total business loss that is attributable to the EZ.

- Business loss is defined under the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA).
- Components of the factors are defined under the provisions of UDITPA.

For taxable years beginning on or after January 1, 1998, business loss is apportioned to the EZ by multiplying the worldwide business loss by a fraction, the numerator of which is the property factor plus the payroll factor, and the denominator of which is two (2).

For taxable years beginning after January 1, 1996 and before January 1, 1998 (1996 fiscal year taxpayers, 1997 year taxpayers), business loss is apportioned to the EZ by use of a four-factor apportionment formula. Worldwide business loss is multiplied by a fraction, the numerator of which is the property factor, payroll factor, and the double-weighted sales factor. The denominator is four (4).

For taxable years beginning on or after January 1, 1991, and ending on or before December 31, 1996 (1991-1995 year taxpayers and 1996 calendar year taxpayers), business loss is apportioned to the EZ by multiplying the worldwide business loss by a fraction, the numerator of which is the property factor plus the payroll factor, and the denominator of which is two (2).

For taxable years beginning before January 1, 1991, business loss attributed to an EZ is determined by multiplying worldwide business loss by a fraction, the numerator of which is the property factor, payroll factor, and sales factor, the denominator of which is three (3).

5510 Property Factor – Loss Apportionment

The property factor is a fraction.

- The numerator of the property factor is the average value of the real and tangible personal property owned or rented and used or available for use by the taxpayer *within the EZ* during the taxable year.
- The denominator is the average value of all real and tangible personal property owned or rented and used or available for use during the taxable year *worldwide.*

Rented property is valued at eight (8) times the net annual rental rate. The net annual rental rate is the total rent paid for the property, less any subrental rates paid by subtenants.

5520 Payroll Factor – Loss Apportionment

The payroll factor is a fraction.

- The numerator of the payroll factor is the total compensation paid to the taxpayer's employees working within the EZ during the taxable year.
- The denominator is the total compensation paid to employees working *worldwide* during the taxable year.

5530 Sales Factor – Loss Apportionment

The sales factor is a fraction.

- The numerator of the sales factor is composed of the gross receipts as defined under the provisions of CR&TC §25134 - 25136, derived during the taxable year from transactions and activities occurring within the taxpayers trade or business in the EZ.
- The denominator is composed of the gross receipts as defined under the provisions of CR&TC §25134 - 25136, derived during the taxable year from transactions and activities related to worldwide operations

General rules regarding the double weighting of the sales factor are applicable.

Example - Two-factor apportionment: For the taxable year ending 12/31/2004, Corp. A operates within and outside an EZ. Corp. A's business loss of $13,000 needs to be apportioned to the EZ. The following amounts apply to Corp. A's property and payroll:

EZ Property	$40,000
Worldwide (WW) Property	$100,000
EZ Payroll	$5,000
WW Payroll	$10,000

EZ Property/WW Property	=.40	
EZ Payroll/WW Payroll	=.50	
	.90/2 = .45	EZ Apportionment Factor

Business loss	$(13,000)
Apportionment Factor	x 0.45
EZ NOL	$(5,850)

5540 Apportionment – Combined Groups

For members of a combined group, the EZ NOL calculation will be based on the combined groups worldwide business loss (before CA apportionment). The numerator of the apportionment formula will be based on each EZ taxpayer's separate EZ payroll and property amounts (and sales as discussed in Section 5530), and the denominator will be based on the combined groups worldwide payroll and property amounts (and sales as discussed in Section 5530).

Example: For the taxable year ending 12/31/2004, Parent Corporation A has two subsidiaries, B and C. Corporations A and B operate within an EZ. The combined group operates within and outside California and apportions its income or loss to California using Schedule R. Assume the combined group's business loss is $1,000,000.

Business loss apportioned to the EZ was determined as follows:

	A	B	C	Combined
<u>Property Factor</u>				
EZ Property	$2,000,000	$1,000,000	$0	$3,000,000
Worldwide Property				$5,000,000
Apportionment %	40%	20%		60%
<u>Payroll Factor</u>				
EZ Payroll	$2,000,000	$800,000	$0	$2,800,000
Worldwide Payroll				$4,000,000
Apportionment %	50%	20%		70%
Average Apport. % (Property + Payroll Factors)/2	45%	20%		65%
Business Loss				$(1,000,000)
EZ NOL	$(450,000)	$(200,000)		$(650,000)

5550 Apportioning for Personal Income Tax Taxpayers

The following examples show the application of the apportioning rules to personal income tax taxpayers.

Example: Ray Smith is vice president of an S corporation that has two locations, one within an EZ and one outside the EZ. Eighty percent (80%) of the S corporation's business is attributable to the EZ. (**Note**: This percentage was determined by the S corporation, using Worksheet V from the FTB 3805Z Business Booklet, at the time the S corporation return was prepared). Ray divides his time equally (50% & 50%) between the two offices of the S corporation.

Mary Smith (Ray's spouse) works for the S corporation at its office located in the EZ.

Ray and Mary Smith have the following 1999 items of California income and expense:

Ray's salary from the S corp.	$100,000
Mary's salary from the S corp.	75,000
Interest on savings account	1,000
Dividends	3,000
Schedule K-1 (100S) from the S corp.	
Ordinary Loss	200,000
EZ business expense deduction	(5,000)*
Ray's unreimbursed employee expenses from Schedule A	(2,000)

*The EZ business expense deduction is a separately stated item on Schedule K-1 (100S).

The Smith's EZ loss is computed as follows:

Ray's EZ salary ($100,000 x 50%)	$50,000
Mary's EZ salary ($75,000 x 100%)	75,000
Pass-through ordinary loss from the S-Corp. ($200,000 x 80%)	(160,000)
EZ business expense deduction from the S-Corp.	(5,000)
Ray's unreimbursed employee business expenses (2,000 x 50%)	(1,000)
Total EZ loss	$(41,000)

Note: The standard deduction and personal or dependency exemptions are not included in the computation of EZ NOL since they are not related to trade or business activities.

5600 CARRYOVER / CARRYBACK

References 17276.1(a); 24416.1(a)

For each taxable year, a qualified taxpayer engaged in a trade or business within a designated EZ may elect to carryover 100% of its NOL. No NOL carrybacks are allowed.

The NOLs may be carried over to each of the 15 taxable years following the year of loss, or until exhausted, whichever occurs first. If an NOL carryover remains after the EZ designation has expired, the EZ shall be deemed to remain in existence for purposes of computing the EZ income limitation and for purposes of allowing the EZ NOL deduction.

5610 Carryover from Years Prior to January 1, 1997

References 17276.1(c); 24416.1(d)

For taxable years beginning on or after January 1, 1997, the EZ incentives were repealed and replaced by new EZ incentives. However, any EZ NOL carryover attributable to taxable years beginning *prior* to January 1, 1997 shall, if previously elected, continue to be carried over as an EZ NOL carryover amount.

5700 EZ NOL DEDUCTION - GENERAL PROVISIONS

References 17276.2(a)(2)(B); 17276.2(a)(2)(C)(ii); 24416.2(a)(2)(B); 24416.2(a)(2)(C)(ii)

The EZ NOL deduction can only offset business income attributable to operations of the taxpayer within the designated EZ.

In the event an EZ NOL deduction is allowable for any taxable year after the EZ designation has expired, the EZ is deemed to remain in existence for the purpose of computing the business income limitation and allowing an EZ NOL deduction.

5710 Business Income Activity Limitation

References 17276.2(a)(2)(C); 24416.2(a)(2)(C)

If a business is located within and outside of an EZ, or in more than one EZ, the taxpayer must determine the portion of the total business income that is attributable to the EZ.

- Business income is defined under the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA).
- Components of the factors are defined under the provisions of UDITPA.

For taxable years beginning on or after January 1, 1998, business income shall be apportioned to the EZ by multiplying the taxpayer's total California source business income by a fraction, the numerator of which is the property factor plus the payroll factor, and the denominator of which is two (2).

For taxable years beginning *after* January 1, 1996 and before January 1, 1998 (1996 fiscal year taxpayers, 1997 year taxpayers), business income is apportioned to the EZ by use of a four-factor apportionment formula. Worldwide business income is multiplied by a fraction, the numerator of which is the property factor, payroll factor, and the double-weighted sales factor. The denominator is four (4).

For taxable years beginning on or after January 1, 1991, and ending on or before December 31, 1996 (1991-1995 year taxpayers and 1996 calendar year taxpayers), business income is apportioned to the EZ by multiplying the worldwide business income by a fraction, the numerator of which is the property factor plus the payroll factor, and the denominator of which is two (2). For an example of apportionment under this method refer to Section 23444.

For taxable years beginning before January 1, 1991, income or loss attributed to an EZ is determined by multiplying worldwide business income or loss by a fraction, the numerator of which is the property factor, payroll factor, and sales factor, the denominator of which is three (3).

5711 Property Factor – Income Apportionment

The property factor is a fraction. The numerator of the property factor is the average value of the real and tangible personal property owned or rented and used or available for use by the taxpayer *within the EZ* during the taxable year.

- For taxable years beginning on or after January 1, 1998, the denominator is the average value of all real and tangible personal property owned or rented and used or available for use by the taxpayer during the taxable year *within California*.

- For taxable years beginning before January 1, 1998, the denominator is the average value of all real and tangible personal property owned or rented and used or available for use during the taxable year *worldwide.*

Rented property is valued at eight (8) times the net annual rental rate. The net annual rental rate is the total rent paid for the property, less any subrental rates paid by subtenants.

5712 Payroll Factor – Income Apportionment

The payroll factor is a fraction. The numerator of the payroll factor is the total compensation paid to the taxpayer's employees working within the EZ during the taxable year.

- For taxable years beginning on or after January 1, 1998, the denominator is the total compensation paid to employees working for the taxpayer *in California* during the taxable year.

- For taxable years beginning before January 1, 1998, the denominator is the total compensation paid to employees working *worldwide* during the taxable year.

5713 Sales Factor – Income Apportionment

The sales factor is a fraction.

- The numerator of the sales factor is composed of the gross receipts as defined under the provisions of CR&TC §25134 - 25136, derived during the taxable year from transactions and activities occurring within the taxpayer's trade or business in the EZ.
- The denominator is composed of the gross receipts as defined under the provisions of CR&TC §25134 - 25136, derived during the taxable year from transactions and activities related to worldwide operations.

General rules regarding the double weighting of the sales factor are applicable.

Example - Two-factor apportionment: For the taxable year ending 12/31/2004, Corp. A operates within and outside an EZ. California business income of $13,000 needs to be apportioned to the EZ. The following amounts apply to Corp. A's property and payroll:

EZ Property	$40,000
CA Property	$100,000
EZ Payroll	$5,000
CA Payroll	$10,000

EZ Property/CA Property	=.40	
EZ Payroll/CA Payroll	=.50	
	.90/2 = .45	EZ Apportionment Factor

Business income	$13,000
Apportionment Factor	x 0.45
EZ Business Income	$5,850

5714 Apportionment – Combined Groups

For taxable years beginning on or after 1/1/1998: For members of a combined group, the limitation will be based on the intrastate apportioned business income for each taxpayer doing business within the EZ. The numerator of the apportionment formula will be based on each enterprise zone taxpayer's separate EZ property and payroll amounts and the denominator will be based on each EZ taxpayer's separate California property and payroll amounts.

For taxable years beginning before January 1, 1998: For members of a combined group, the credit limitation will be based on the combined groups worldwide business income (before CA apportionment). The numerator of the apportionment formula will be based on each EZ taxpayer's separate EZ payroll and property amounts (and sales as previously discussed), and the denominator will be based on the combined groups worldwide payroll and property amounts (and sales as previously discussed). For an example of apportionment under this method refer to Section 23444.

Example: For the taxable year ending 12/31/2004, parent corporation A has two subsidiaries, B and C. Corporations A and B operate within the EZ. The combined group operates within and outside California and apportions its income to California using Schedule R. Assume the combined group's business income apportioned to California was $1,000,000 and corporation A and B's share of California business income was $228,000 and $250,000 respectively. Corporation A and B's separate EZ and separate California property and payroll factor amounts are shown below.

Business income apportioned to the EZ was determined as follows:

	A	B
<u>Property Factor</u>		
EZ Property	$1,000,000	$ 800,000
California Property	$1,000,000	$1,200,000
Apportionment %	100%	66.66%
<u>Payroll Factor</u>		
EZ Payroll	$800,000	$ 800,000
California Payroll	$800,000	$1,000,000
Apportionment %	100%	80%
Average Apport. % (Property + Payroll	100%	73.33%

Factors)/2

Apportioned Business Income	$228,000	$250,000
EZ Income	$228,000	$183,333

5715 Apportioning for Personal Income Tax Taxpayers

The following examples show the application of the apportioning rules to personal income tax taxpayers.

Example: Ray Smith is vice president of an S corporation that has two locations, one within an EZ and one outside the EZ. Eighty percent (80%) of the S corporation's business is attributable to the EZ (**Note**: This percentage was determined by the S corporation, using Worksheet V from the FTB 3805Z Business Booklet, at the time the S corporation return was prepared). Ray divides his time equally (50% & 50%) between the two offices of the S corporation.

Mary Smith (Ray's spouse) works for the S corporation at its office located in the EZ.

Ray and Mary Smith have the following 1999 items of California income and expense:

Ray's salary from the S corp.	$100,000
Mary's salary from the S corp.	75,000
Interest on savings account	1,000
Dividends	3,000
Schedule K-1(100S) from the S corp.	
Ordinary income	40,000
EZ business expense deduction	(5,000)*
Ray's unreimbursed employee expenses from Schedule A	(2,000)

*The EZ business expense deduction is a separately stated item on Schedule K-1 (100S).

The Smith's EZ income is computed as follows:

Ray's EZ salary ($100,000 x 50%)	$50,000
Mary's EZ salary ($75,000 x 100%)	75,000
Pass-through ordinary income from the S-Corp. ($40,000 x 80%)	32,000
EZ business expense deduction from the S-Corp.	(5,000)
Ray's unreimbursed employee business expenses (2,000 x 50%)	(1,000)
Total EZ income	$151,000

Note: The standard deduction and personal or dependency exemptions are not included in the computation of EZ income since they are not related to trade or business activities.

5800 NOL SUSPENSIONS

References 17276.3(c); 24416.3(c)

For taxable years beginning in 2002 and 2003, California has suspended the Net Operating Loss (NOL) carryover deduction. Taxpayers may continue to compute and carryover an NOL during the suspension period. The carryover period for suspended losses is extended by two years for losses incurred before January 1, 2002 and by one year for losses incurred after January 1, 2002 and before January 1, 2003. The deduction for disaster losses is not affected by the NOL suspension rules.

Enterprise Zone NOLs incurred by qualified taxpayers are *not* suspended for taxable years beginning in 1991 and 1992.

5900 ALTERNATIVE MINIMUM TAX

References 17062; 23456

Taxpayers claiming an EZ NOL deduction must also determine their NOL for alternative minimum tax purposes.

6000 ENTERPRISE ZONE NET INTEREST DEDUCTION

California Revenue & Taxation Code (CR&TC) Sections 17235 and 24384.5 provide for the deduction of net interest income for loans made to a trade or business located solely within an Enterprise Zone (EZ). The net interest deduction is for interest payments received after the designation of the EZ and before its expiration.

6100 GEOGRAPHIC BOUNDARIES AND DESIGNATION DATES

For a listing of EZs and designation dates, refer to Section 1310. To verify an address, refer to Section 1300.

6200 QUALIFIED TAXPAYER

References 17235(a)&(b); 24384.5(a)&(b)

For purposes of the EZ net interest deduction, a qualified taxpayer (creditor) is defined as a person or entity that loans funds on or after the designation date of the EZ to a qualified business (debtor) and receives interest payments thereon. The loan advanced to the qualified business must also meet the requirements as discussed in Section 6300.

The taxpayer (creditor) does not have to be located in the EZ to take advantage of the net interest deduction. Only the debtor needs to operate within the EZ (see Section 6600).

6210 Pass-Through Entities

In the case of any pass-through entity, the determination of whether a taxpayer is a qualified taxpayer is made at the entity level.

6300 QUALIFIED DEBT

References 17235(b); 24384.5(b)

In order for the taxpayer (creditor) to claim the net interest deduction for creditors, the following requirements must be met *at the time the indebtedness is incurred*:

- The trade or business (qualified business/debtor) to which the loan is made is located *solely* within an EZ.
- The indebtedness is incurred *solely* in connection with activity within the EZ.
- The creditor has no equity or other ownership interest in the debtor.

> **Note:** The requirements of CR&TC §17235(b) & 24384.5(b) are only tested at the time the loan originated. The CR&TC does not provide for any limitation after the loan is made. For instance, if two years after the qualified loan is made, the debtor contacts the creditor to renegotiate the loan terms due to the debtor's poor financial condition. The creditor agrees to take an equity interest in the debtor in exchange for reducing the amount due from the debtor. Net interest received from the remaining portion of the qualified loan would still be deductible because the creditor's equity interest occurred subsequent to loan origination.

The debtor however, must satisfy the requirements of CR&TC §17235(a) & 24384.5(a) annually.

- The debtor must continue to conduct business in the EZ annually.

Example*:* Two years after the qualified loan is funded, the qualified business/debtor moves their operations entirely outside of the EZ. The net interest deduction is no longer allowed because the trade or business is not located within the EZ. CR&TC §17235(a) & 24384.5(a) is an annual test that only requires that *a business be engaged in a trade or business within the zone*. It does not use the more restrictive language of CR&TC §17235(b)(1) & 24384.5(b)(1) that require that the business be *solely located with the zone* which is checked at the time the debt is incurred.

6310 Security/Collateral

The statute does not require that the security or collateral for the loan be located in the EZ. For example, a sole proprietor can use its personal residence as collateral for the EZ business loan and the creditor is still allowed the net interest deduction assuming all other qualifications are met.

6400 DEFINITION OF "QUALIFIED BUSINESS/DEBTOR"

The definition of a qualified business/debtor requires a review of the debtor. The business activity of the debtor (entirely or a portion thereof as relevant) must be conducted within the EZ; this is an annual test. This should not be confused with the *Solely Located* requirement (refer to Section 6600), required at the time the loan is originated.

6500 DEFINITION OF A "TRADE OR BUSINESS"

Black's Law Dictionary defines "trade or business" as "any business or professional activity conducted by a taxpayer, the objective of which is to earn a profit." The Internal Revenue Code (IRC) and the R&TC also reference the definition of a trade or business as an activity engaged in for profit. The statute uses the broad term "trade or business," the plain meaning of which includes all types of conduct in furtherance thereof. A logical reading of "any business or professional activity conducted by a taxpayer" requires that all of the taxpayer's activities (passive or active) connected to the conduct of a trade or business are a part of the trade or business. Accordingly, personnel and assets involved in the administration and management of assets, manufacture of goods, sale of goods, shipment of goods, delivery of goods and services, etc., are a part of a trade or business.

6600 DEFINITION OF "BUSINESS LOCATED SOLELY WITHIN"

References 17235(b)(1); 24384.5(b)(1)

In order to claim the net interest deduction at the time the loan is originated, the loan must be made to a qualified business *located solely within* (and for an activity solely in connection with; see Section 6650) an EZ. Whether or not the debtor is engaged in a trade or business located solely within the enterprise zone is determined by examining:

- The physical location *and* use of the debtor's business assets.
- The physical locations at which the debtor's employees perform services for the debtor.

The presence of the qualified trade or business' payroll and tangible property exclusively within an EZ would be a strong indication that they meet the test. The fact that sales are delivered by common carrier outside of the EZ would not cause the borrower to fail the located solely within requirement.

Example: The debtor operates a retail convenience store located within the EZ as a sole proprietorship. The store conducts all of its business with its customers on a retail basis within the store. The store makes no deliveries. The creditor provides a loan to the debtor for upgrades to the store's refrigeration units. The loan qualifies the creditor to take the net interest deduction. The debtor operates a trade or business located solely within an EZ.

6650 Definition of "Activity Solely Within"

References 17235(b)(2); 24384.5(b)(2)

The indebtedness is incurred solely in connection with activity within the EZ. The borrowed funds must be used for the business activity entirely within the EZ.

6700 NET INTEREST DEDUCTION - COMPUTATION

For purposes of determining the net interest deduction, *net interest* is gross interest received less related interest expense (cost of funds) and any other directly related expenses.

6710 Gross Interest

Substantial differences may exist between *tax* and *book* accounting methods. Consequently, the amount of gross interest income included in the computation of net interest is determined using the creditor's tax accounting method (i.e., the gross interest income included in the computation of net interest corresponds to the gross interest income included in the determination of taxable income). Gross interest income should not include items that are *not* in the nature of interest.

Interest is defined as an amount paid for the use or forbearance of money.

Gross interest may be determined by referencing the loan contract. A contract between a creditor and a qualified trade or business may include all of the following:

- A stated rate of interest

- Points
- Commitment fees (fees for entering into an agreement that obligates the lender to make funds available for an agreed period at a stated rate of interest - see Rev. Rul. 70-540)*
- Service fees (fee charged for processing a loan)
- Escrow interest

Analysis of each of the above items is necessary to determine which are in the nature of interest. For example, commitment fees and service fees are not included in gross interest for purposes of determining the net interest deduction as they are fees earned when establishing the loan and are not monies paid for the use of the loaned funds.

Points are a charge by the lender, in addition to the stated rate of interest, to reflect the actual cost of borrowing money. Thus, points as described here, are for the use or forbearance of money and are considered to be interest. Escrow interest is interest from the date the loan is funded until 30 days before the borrower's first loan payment. Original issue discount (OID) is another form of interest. Stated interest, points, escrow interest, and OID are all items that may be included in gross interest for purposes of determining the net interest deduction.

* Revenue Ruling 70-540, 1970-2 CB 101 discusses the character of commitment fees from the lender's point of view. The commitment fee is a charge for agreeing to make funds available rather than for the use or forbearance of money, and therefore, is not interest. Other revenue rulings discuss commitment fees from the point of view of the borrower. To the extent of any discussion concerning the treatment of points by the lender, Rev. Rul. 70-540 was made obsolete by Rev. Proc. 94-29, 1994-1 CB 616; this does not affect its relevance in regards to commitment fees.

6720 Cost of Funds

A reasonable amount of interest expense must be assigned to the interest income. One method of determining a reasonable cost of funds is the following formula:

$$\frac{\text{Interest Expense}}{\text{Funding Sources}} = \text{Cost of Funds}$$

Funding sources are equal to average liabilities plus owners' equity less average non-interest earning assets.

The ratio from the above formula is multiplied by the average loan principal outstanding for the year. All amounts are on a tax basis.

For example, assume the following is from the tax return of a financial institution:

Average liabilities and owners' equity	$53,000,000,000
LESS: Average non-interest earning assets	7,000,000,000
Funding Sources	$46,000,000,000

Total Interest Expense	$ 1,500,000,000	
Funding Sources	$46,000,000,000	= 3.26%

Assume that an average principal amount of $10 million was outstanding during the year for loans made to businesses within an EZ. A reasonable amount of interest expense to assign to the loans is $326,000 ($10 million times 3.26%).

Taxpayers may also use an independent cost of funds index such as the prime index rate or the London Interbank Offered Rate (LIBOR), which is the rate banks use to place Eurodollars with one another in London. If an independent index is used, that index must approximate the taxpayer's cost of funds.

The annual report of many banks or savings and loan associations provides the average cost of funds. The net interest margin (the difference between interest income and interest expense) is usually of interest to shareholders and other users of the annual report. The net interest margin should be similar to that used for the calculation of the net interest deduction.

6730 Other Related Expenses

"Net interest" is interest received less the cost of funds and direct expenses incurred in earning such interest. An example of a direct expense is commission paid to a loan representative. Expenses that are not directly attributable to the loan in question should not be subtracted for purposes of determining the net interest deduction.

All reasonably identifiable direct costs applicable to acquiring or making a loan should be capitalized and written off over the life of the loan. The amortization method should reflect the nature of the loan. It would be reasonable to use straight line or principal reduction methods of amortization (see Rev. Proc. 94-29 for application of the principal reduction method).

6740 Non-Bank & Financial Lenders

Non-financial corporations and individuals usually do not have all of the various income and expense items referred to previously.

Generally, gross interest of non-bank or non-financial creditors will be the interest income as stated in the loan. For example, an individual creditor will generally avoid escrow interest by establishing the monthly due date of the loan as the day of the month the loan was funded, or the day escrow closed, whereas mortgages carried by a commercial lender generally have a common due date (i.e., the beginning of the month).

Related expenses, such as the cost of funds, must be determined in order to compute the deduction of net interest income. Non-bank or non-financial lenders who make loans to qualified businesses located solely within the EZ may incur investment interest expense related to such loans. The interest tracing rules under Treas. Reg. §1.163-8T are appropriate for determining related interest expense for these taxpayers.

6800 EXPIRATION OF EZ DESIGNATION

References 17233; 24385

Generally, once the EZ designation expires, becomes inoperative, or ceases to exist, the net interest deduction is not allowed because the trade or business is no longer located within the designated EZ (See Section 1200 for a complete listing of expired EZs).

However, for purposes of conditionally designated enterprise zones, wherein the conditionally designated zone includes the debtor's business location and the designation date of the new loan immediately follows the expiration of the new zone, the net interest deduction can continue as a qualified deduction amount under the new enterprise zone.

6900 RECORD KEEPING

The qualified taxpayer/creditor should maintain records on each loan (loan agreements) for which a deduction of net interest is taken. The records should identify or describe:

- The debtor.
- The debtor's location (at the time of indebtedness and annually).
- The debtor's mailing address.
- The purpose/use of the loan.
- The stated interest.
- Other items included in gross interest.
- Any direct expenses associated with the loan.
- Any property securing the loan.

7000 ENTERPRISE ZONE EMPLOYEE WAGE CREDIT

References 17053.75

A credit is available to qualified employees who earn qualified wages. The credit is equal to 5% of the employee's qualified wages for the year. The maximum credit may not exceed $525.

7100 QUALIFIED EMPLOYEE

A qualified employee must meet *all* of the following requirements:

- At least 90% of the employee's work time is spent on activities that are directly related to the conduct of a trade or business within an EZ.
- At least 50% of the employee's work is performed within an EZ.
- The employee is *not* an employee of the federal government, the state of California, or a local government.

For information about the geographic boundaries of an EZ, refer to Section 2100.

7200 QUALIFIED WAGES

Qualified wages are those wages attributable to services performed by a qualified employee that do not exceed $10,500 for any taxable year. Qualified wages do not include compensation received from the federal government, the state of California, or a local government. In addition, qualified wages do not include any wages received on or after the date the EZ designation expires, is no longer binding, or becomes inoperative. A large number of EZs expired in 2006 and 2007 (refer to Section 1200 for a complete listing of expired EZs).

7300 CREDIT LIMITATIONS & INCOME LIMITATION

7310 Credit Limitation

The maximum amount of qualifying wages is $10,500. For each dollar of income received by the employee that is in excess of the qualified wages ($10,500), the credit shall be reduced by nine cents ($0.09).

7320 Zone Income Limitation

For each eligible taxable year, the credit may only offset taxes due on the income earned within the EZ.

7400 CREDIT USAGE AND CARRYOVER

This credit may not reduce regular tax below the tentative minimum tax (TMT).

There are no carryover provisions for the EZ Employee Wage credit. Any unused credit is not refundable and the credit may not be carried over to succeeding tax years.

7500 ENTERPRISE ZONE EXPIRATION

A large number of EZs expired in 2006 and 2007 (refer to Section 1200 for a complete listing of expired EZs). The EZ employee wage credit is available for qualified employee on qualified wages received on or before the expiration date.

Note: The statute specifically provides that wages received are eligible for computing the employee wage credit. CR&TC §17053.75(a) Wages received does not include accrued wage amounts, or those amounts paid but not actually or constructively received by the employee.

Section 8000 TARGETED TAX AREA HIRING CREDIT

References 17053.34; 23634

For each taxable year beginning on or after January 1, 1998, the California Revenue & Taxation Code (CR&TC) provides a hiring credit for "qualified" taxpayers who operate or invest in a business located within the designated Target Tax Area (TTA). The "qualified" taxpayer must hire "qualified employees" and pay them "qualified wages". The TTA was established in California to stimulate development in selected economically depressed areas.

The TTA hiring credit applies to those employees hired after the designation date of the TTA.

8100 GEOGRAPHIC BOUNDARIES AND DESIGNATION DATE

For a listing of TTA cities, see "*TTA Locations and Designation Date*" EDAM 1340. To verify an address, refer to EDAM 1300.

8200 Qualified Taxpayer

References 17053.34(b)(5)(A); 23634(b)(5)(A)

EDAM 8210	Pass-Through Entities
EDAM 8220	Controlled Groups
EDAM 8230	Acquired Businesses

A *qualified taxpayer* is:

- A person or entity that is engaged in a trade or business within the TTA and whose trade or business is described in the following Standard Industrial Classification (SIC) Manual (1987 edition) code sections:
    - Codes 2000 through 2099
    - Codes 2200 through 3999
    - Codes 4200 through 4299
    - Codes 4500 through 4599
    - Codes 4700 through 5199
- A taxpayer that obtains and retains certification (voucher) as discussed in EDAM 8430 which provides that a qualified employee meets the eligibility requirements applicable immediately preceding commencement of employment with the taxpayer as discussed in EDAM 8400.

NOTE: Failure to obtain the certification (voucher) results in the taxpayer not meeting all the qualifications of a qualified taxpayer eligible for the hiring credit. A taxpayer must obtain certification (voucher).

8210 Pass-Through Entities

The determination of whether a taxpayer is a qualified taxpayer is made at the entity level. The term "pass-through entity" means any partnership or S corporation. The hiring tax credit is allowed to the pass-through entity and passed through to the partners or shareholders.

8220 Controlled Groups

References 17053.34(e)(1); 23634(e)(1)

All employees of trades or businesses that are under common control, or members of the same controlled group of corporations, are treated as employed by a single taxpayer.

A controlled group of corporations is defined in IRC § 1563(a) as modified by the California Revenue & Taxation Code, to replace "*at least 80%*" with "*more than 50%*". The determination is made without regard to subsections (a)(4) and (e)(3)(C) of IRC § 1563.

NOTE: Controlled groups of taxpayers may not transfer employees between members to trigger or increase the credit.

8230 Acquired Businesses

References 17053.34(e)(2); 23634(e)(2)

For purposes of the hiring credit, if a major portion of a business is acquired from another employer, the employment relationship between the employee and the new employer is not deemed terminated if the employee continues employment in that business. Also, if a major portion of a separate unit of a business predecessor is acquired, the employment relationship between the employee and the new employer is not deemed terminated if the employee continues employment in that business.

NOTE: The new employer, “steps into the shoes” of the old employer for purposes of incurring future credits.

8300 Qualified Wages

References 17053.34(b)(1); 17053.34(b)(2); 17053.34(g); 23634(b)(1); 23634(b)(2)

EDAM 8310	Estates and Trusts
EDAM 8320	Non-Qualified Wages
EDAM 8330	Minimum Wage Chart

Qualified wages are wages paid or incurred to employees (qualified) during the consecutive 60-month period beginning with the first day the employee commences employment with the taxpayer. For qualified employees hired before the expiration date of the TTA, qualified wages paid or incurred within the 60-month period beginning with the first day the employee commences employment with the taxpayer shall continue to qualify for the credit after the area expiration date, as if the TTA designation were still in existence and binding.

Qualified *wages* means that portion of hourly wages that does not exceed 150% of the minimum wage.

- Minimum wage means the wage established by the Industrial Welfare Commission. When the California minimum wage is higher than federal minimum wage, use the California minimum wage for purposes of this credit.
- To determine a salaried employee's hourly wage, generally, you divide the total salary by the hours on which the salary is based, normally 2,000 hours per year.

8310 Estates and Trusts

In the case of an estate or trust, the qualified wages are apportioned between the estate/trust and the beneficiaries on the basis of the income allocable to each. Consequently, any beneficiary, to whom wages are apportioned, is treated as the employer with respect to those wages.

8320 Non-Qualified Wages

Qualified wages *do not* include any wages paid or incurred on or after the area expiration date except as noted previously for qualified employees hired prior to the expiration of the TTA.

8330 Minimum Wage Chart

EFFECTIVE DATE	MINIMUM WAGE	MAXIMUM HOURLY WAGE (150% of Minimum Wage)
March 1, 1998 to December 31, 2000	$5.75	$8.62
January 1, 2001 to December 31, 2001	$6.25	$9.37
January 1, 2002 to Current	$6.75	$10.12

8400 Qualified Employee

References 17053.34(b)(4)(A); 23634(b)(4)(A)

EDAM 8410 Seasonal Employees
EDAM 8420 Leased Employees
EDAM 8430 Vouchering Form TCA EZ1

A qualified employee is an individual who satisfies all of the following:

ANNUAL TESTS
At least 90% of the individual's work for the taxpayer, during the taxable year, is directly related to the conduct of the taxpayer's trade or business located within the TTA; and
At least 50 percent of the individual's services for the taxpayer, during the taxable year, are performed within the boundaries of the TTA;

TIME OF HIRE TESTS

- The individual is hired after the area was designated as a TTA; and
- Immediately prior to commencement of employment with the taxpayer, the individual is any of the following:
  1. Eligible for services under the federal Job Training Partnership Act (JTPA) or its successor;
  2. Eligible to be a voluntary or mandatory registrant under the Greater Avenues for Independence (GAIN) Act of 1985, or its successor;
  3. An economically disadvantaged individual 14 years of age or older;
  4. A qualified dislocated worker (refer to the CR&TC or the FTB 3809 Business Booklet for an expanded definition);
  5. A disabled individual who is eligible for, enrolled in, or who has completed a state rehabilitation plan;
  6. A service-connected disabled veteran;
  7. A veteran of the Vietnam era;
  8. A veteran who recently separated from military service;
  9. An ex-offender;
  10. A person eligible for, or a recipient of any of the following:
      - Federal Supplemental Security Income (SSI) benefits;
      - Aid to Families with Dependent Children (AFDC);
      - Food stamps; or
      - State and local general assistance.
  11. A Native American;
  12. A resident of the TTA; or
  13. A member of a targeted group, as defined in IRC § 51(d), or its successor.

8410 Seasonal Employees

References 17053.34(b)(1)(B); 17053.34(b)(6); 23634(b)(1)(B); 23634(b)(6)

"Seasonal employment" means employment that has regular and predictable substantial reductions in business operations.

Reemployment of an individual, in connection with any increase (including a regularly occurring seasonal increase) in business operations, does not constitute commencement of employment for purposes of the TTA hiring credit.

8420 Leased Employees

The "employer" is the qualified taxpayer and may qualify for the hiring credit for leased employees. The employer can be either the leasing company or the subscriber to the leasing company. Generally, the employer has the legal obligation to pay the payroll taxes of the employee, and has the right to control and direct the workers (employee's) services.

Internal Revenue Service (IRS) Publication 15-A, Employer's Supplemental Tax Guide provides guidelines for establishing an employment relationship and provides examples to consider in determining the employer-employee relationship.

8430 Vouchering Form TCA EZ1

References 17053.34(d); 23634(d)

The *Form TCA EZ1* is the certification, (voucher) which provides that the qualified employee meets the eligibility requirements of a qualified employee as discussed in EDAM 8400. The qualified taxpayer shall get *Form TCA EZ1* from one of the following applicable entities:

- The Employment Development Department (EDD);
- The local county JTPA administrative entity;
- The local city JTPA administrative entity;
- The local county GAIN office; or
- The social services agency.

The qualified taxpayer needs to retain a copy of the certification (voucher) and provide it upon request to the Franchise Tax Board.

NOTE: Failure to obtain the certification (voucher) results in the taxpayer not meeting all the qualifications of a qualified taxpayer eligible for the hiring credit. A taxpayer must obtain certification (voucher).

8500 Credit Computation

References 17053.34(a); 23634(a)

EDAM 8510	Credit Limitation - Exclusive Credit
EDAM 8520	Wage Expense Reduction
EDAM 8530	Business Income Activity Limitation
EDAM 8540	General Provisions – Apportionment of Business Income
EDAM 8541	Property Factor – Income Apportionment
EDAM 8542	Payroll Factor – Income Apportionment
EDAM 8543	Apportionment – Combined Groups
EDAM 8544	Apportioning for Personal Income Tax Taxpayers
EDAM 8550	S Corporations

For each taxable year beginning on or after January 1, 1998, a hiring credit is allowed to a qualified taxpayer for hiring a qualified employee for employment within the TTA. The credit is equal to the sum of each of the following:

- 50% of the qualified wages during the first year of employment.
- 40% of the qualified wages during the second year of employment.
- 30% of the qualified wages during the third year of employment.
- 20% of the qualified wages during the fourth year of employment.
- 10% of the qualified wages during the fifth year of employment.

The credit percentage is based on the employee's date of employment and subsequent anniversary dates. The taxpayer's taxable year does not control the applicable credit percentages. With the exception of the first and last year of the credit, within one taxable year, two percentage ranges for the computation of the credit may apply.

Example: An employee was hired 7/1/1998, and the taxpayer is completing the tax return for the year ending 12/31/1999. For the period 1/1/1999 to 6/30/1999, the hiring credit is based on 50% of qualified wages. For the period 7/1/1999 to 12/31/1999, the hiring credit is based on 40% of qualified wages.

Once the employee commences employment, the credit percentage range begins and generally is not interrupted in the event of a subsequent layoff and rehire of the employee.

Example: An employee is hired 7/1/1998, is temporarily laid off 2/1/1999, and is rehired 4/1/1999. The 50% credit range runs from 7/1/1998 to 6/30/1999 regardless of the layoff period between 2/1/1999 and 3/31/1999.

8510 Credit Limitation - Exclusive Credit

References 17053.34(c); 23634(c)

If the qualified taxpayer is allowed the TTA hiring credit for qualified wages paid to an employee, only that one credit is allowed to the taxpayer with respect to those qualified wages for that employee.

8520 Wage Expense Reduction

References 17053.34; 23634

There is no corresponding wage expense reduction if a taxpayer utilizes the TTA hiring credit.

8530 Business Income Activity Limitation

References 17053.34(j); 23634(j)

The amount of hiring credit or the sales or use tax credit (see EDAM 9700) claimed, including any credit carryover from prior years, may not exceed the amount of tax on the TTA business income in any taxable year. The TTA business income is that portion of the taxpayer's *California source* business income that is apportioned to the TTA. Non-business income or loss is not included in the calculation of business income from the TTA.

Example: Corp. A operates entirely within the TTA. In order to determine the amount of hiring credit allowable, the business income and the tax on that business income must be determined. Corp. A has the following items of income and expense:

Income from business operations	$30,000
Interest from investment which is unrelated to Corp. A's business operations	$2,000
Business expenses	(17,000)
Net Taxable Income	$15,000

Corp. A's income attributed to business operations is:

Income from business operations	$30,000
Business expenses	(17,000)
Net Business Income	$13,000

To determine the TTA hiring credit allowable, the net business income is multiplied by the current tax rate.

Net Business Income	$13,000
x 8.84%	x .0884
Tax associated with business income	$1,149

In this example, the taxpayer can offset the tax of $1,149 with the hiring credit available (up to $1,149).

NOTE: "net tax"/"tax" and alternative minimum tax impose limitations on the allowable offset but were not considered a factor in this example.

8540 General Provisions – Apportionment of Business Income

References 17053.34(j)(2); 23634(j)(2); 23634(j)(3)

If a business is located within and outside of a TTA, the taxpayer must determine the portion of the total business income that is attributable to each TTA.

- Business income is defined under the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA).
- Components of the factors are defined under the provisions of UDITPA.

Business income is apportioned to the TTA by multiplying the taxpayer's *California* source business income by a fraction, the numerator of which is the property factor plus the payroll factor, and the denominator of which is two (2).

8541 Property Factor – Income Apportionment

The property factor is a fraction. The numerator of the property factor is the average value of the real and tangible personal property owned or rented and used or available for use by the taxpayer *within the TTA* during the taxable year. The denominator is the average value of all real and tangible personal property owned or rented and used or available for use by the taxpayer during the taxable year *within California*.

Rented property is valued at 8 times the net annual rental rate. The net annual rental rate is the total rent paid for the property, less any subrental rates paid by subtenants.

8542 Payroll Factor – Income Apportionment

The payroll factor is a fraction. The numerator of the payroll factor is the total compensation paid to employees working for the taxpayer *within the TTA* during the taxable year. The denominator is the total compensation paid to employees working for the taxpayer *within California* during the taxable year.

Example: Corp. A operates within and outside a TTA. California business income of $13,000 needs to be apportioned to the TTA. The following amounts apply to Corp. A's property and payroll:

TTA Property	$40,000
CA Property	$100,000
TTA Payroll	$5,000
CA Payroll	$10,000

TTA Property/CA Property	=. 40	
TTA Payroll/CA Payroll	=. 50	
	.90/2 = .45	TTA Apportionment Factor

Business income	$13,000
Apportionment Factor	x 0.45
TTA Business Income	$5,850
Current Tax Rate	x .0884
Tax attributable to TTA business income	$517

8543 Apportionment – Combined Groups

For members of a combined group, the limitation will be based on the intrastate apportioned business income for each taxpayer doing business within the TTA. The numerator of the apportionment formula will be based on each TTA taxpayer's separate TTA property and payroll amounts and the denominator will be based on each TTA taxpayer's separate California property and payroll amounts.

Example: For the taxable year ending 12/31/99, parent corporation A has two subsidiaries, B and C. Corporations A and B operate within the TTA. The combined group operates within and outside California and apportions its income to California using Schedule R. The combined group's business income apportioned to California was $1,000,000. Corporation A and B's share of California business income is $228,000 and $250,000 respectively. Corporation A and B's separate TTA and separate California property and payroll factor amounts are shown below.

Business income apportioned to the TTA was determined as follows:

	A	B
Property Factor		
TTA Property	$1,000,000	$ 800,000
California Property	$1,000,000	$1,200,000
Apportionment %	100%	66.66%
Payroll Factor		
TTA Payroll	$800,000	$ 800,000
California Payroll	$800,000	$1,000,000
Apportionment %	100%	80%
Average Apport. % (Property + Payroll Factors)/2	100%	73.33%
Apportioned Business Income	$228,000	$250,000
TTA Income	$228,000	$183,333

8544 Apportioning for Personal Income Tax Taxpayers

The following examples show the application of the apportioning rules to personal income tax taxpayers.

Example: Ray Smith is vice president of an S corporation that has two locations, one within a TTA and one outside the TTA. Eighty percent (80%) of the S corporation's business is attributable to the TTA. (**NOTE**: This percentage was determined by the S corporation, using Worksheet IV from the FTB 3809 Business Booklet, at the time the S corporation return was prepared). Ray divides his time equally (50% & 50%) between the two offices of the S corporation.

Mary Smith (Ray's spouse) works for the S corporation at its office located in the TTA.

Ray and Mary Smith have the following 1999 items of California income and expense:

Ray's salary from the S corp.	$100,000
Mary's salary from the S corp.	75,000
Interest on savings account	1,000
Dividends	3,000
Schedule K-1(100S) from the S corp.	
Ordinary income	40,000
TTA business expense deduction	(5,000)*
Ray's unreimbursed employee expenses from Schedule A	(2,000)

*The TTA business expense deduction is a separately stated item on Schedule K-1 (100S).

The Smith's TTA income is computed as follows:

Ray's TTA salary ($100,000 x 50%)	$50,000
Mary's TTA salary ($75,000 x 100%)	75,000
Pass-through ordinary income from the S-Corp. ($40,000 x 80%)	32,000
TTA business expense deduction from the S-Corp.	(5,000)
Ray's unreimbursed employee business expenses (2,000 x 50%)	(1,000)
Total TTA income	$151,000

Ray and Mary must compute the tax on the total TTA income of $151,000 (as if it represents all of their income). Using the tax rate schedule for the filing status *married* *filing joint*; the 1999 tax on $151,000 is $10,659. The $10,659 is the first limitation on TTA credits for the 1999 taxable year. The second limitation on the credits is the *net tax* on all income.

NOTE: The standard deduction and personal or dependency exemptions are not included in the computation of TTA income since they are not related to trade or business activities.

8550 S Corporations

References 23803(a)(1)(A); 23803(a)(1)(F)

An S corporation's hiring credit may reduce the TTA tax at both the corporate and shareholder levels. However, the S corporation may only use one-third (1/3) of the credit to reduce the tax on the S corporation's TTA income.

One hundred percent (100%) of the TTA credit is passed through to the S corporation shareholders. The full amount of the credit is reported on Schedule K (100S) and passed through to the shareholders on Schedules K-1 (100S).

8600 Credit Usage & Carryover

References 17053.34(i); 17053.34(j)(1); 17053.34(j)(4); 23634(i); 23634(j)(1); 23634(j)(4)&(5)

EDAM 8610	Credit Will Not Reduce Certain Taxes
EDAM 8620	Credit Recapture
EDAM 8621	Non-Seasonal Employees
EDAM 8622	Seasonal Employees
EDAM 8623	Credit Recapture – Exceptions
EDAM 8624	Change in the Form of the Trade or Business

The total amount of the TTA hiring credit and sales or use tax credit, including any credit carryover from prior years, that may reduce the "tax"/"net tax" for the taxable year, shall not exceed the amount of tax imposed on the taxpayer's business income attributable to the TTA, determined as if that income represented all of the income of the taxpayer.

The portion of the credit that exceeds the "tax"/"net tax" for the taxable year, is carried over and added to the credit, if any, in the following year. The credit is carried over to succeeding years, until it is exhausted.

If a credit carryover remains after the TTA has expired or is revoked, the TTA is deemed to remain in existence for purposes of computing the taxpayer's business income attributable to the TTA.

Example: A taxpayer has a $4,900 TTA hiring credit. Tax imposed on TTA business income is $4,700 and the taxpayer's overall "net tax"/"tax" is $4,000. The taxpayer would be eligible to claim a $4,000 maximum hiring credit.

Total hiring credit	$4,900
Tax on TTA income	$4,700
First limitation:	
Lesser of total credit or tax on TTA income	$4,700
Second limitation:	
Lesser of tax on TTA income or "*net tax*"/"*tax*"	$4,000
Maximum credit allowed:	
Lesser of *TTA tax limitation* or "*net tax*"/"*tax*" *limitation*	$4,000
Total hiring credit	$4,900

Maximum credit allowed	$4,000
Carryover	$ 900

8610 Credit Will Not Reduce Certain Taxes

The TTA hiring credit *cannot* reduce the:

- Minimum franchise tax (corporations, limited partnerships, limited liability partnerships, LLCs, and S corporations);
- Annual tax (partnerships, LLCs classified as partnerships, and Qsubs);
- Built-in gains tax (S corporations);
- Excess net passive income tax (S corporation); or
- Alternative minimum tax (corporations, exempt organizations, individuals and fiduciaries).

The TTA hiring credit can reduce the regular tax below tentative minimum tax (TMT).

8620 Credit Recapture

References 17053.34(f)(1); 17053.34(f)(3); 23634(f)(1); 23634(f)(3)

8621 Non-Seasonal Employees

Recapture of the hiring credit is required if the employee is terminated before the end of the longer of the following two periods:

- The first 270 "days of employment" (whether or not consecutive); or
- Ninety (90) "days of employment" plus 270 calendar days.

To recapture the credit, the taxpayer must add to the current year's tax the amount of credit claimed for the year of termination, as well as all prior year credit claimed for the terminated employee.

8622 Seasonal Employees

For taxable years beginning on or after January 1, 1998, for seasonal employees, the taxpayer must recapture the amount of the credit if employment is terminated before the completion of 270 "days of employment" during the 60-month period beginning the day the employee commences employment with the taxpayer.

To recapture the credit, the taxpayer must add the amount of credit previously claimed in all years to the tax for the taxable year that includes the 60th month of employment.

A ‘‘day of employment’’ includes any day the employee was paid to work, regardless of whether the employee actually worked (including paid holidays, sick days, and vacation days).

NOTE: Any increase in tax, due to credit recapture, cannot be offset by the current year hiring credit.

8623 Credit Recapture – Exceptions

References 17053.34(f)(2)(A); 17053.34(f)(2)(B); 23634(f)(2)(A); 23634(f)(2)(B)

For both regular and seasonal employees, the credit recapture will not apply if the termination was:

- Voluntary on the part of the employee;
- Caused by the employee becoming disabled;
- Due to employee misconduct;
- Due to a substantial reduction in business; or
- In order to enable other qualified employees to be hired, creating an increase in the number of qualified employees and the hours of employment.

8624 Change in the Form of the Trade or Business

References 17053.34(f)(2)(C); 23634(f)(2)(C)

The employment relationship between the taxpayer and an employee is not treated as terminated by reason of a mere change in the form of conducting the trade or business. If the employee continues employment in that trade or business and the taxpayer retains a substantial interest in that trade or business, the employee is not treated as terminated. In addition, transactions in which IRC § 381(a) applies will not trigger recapture if the employee continues employment by the acquiring corporation.

8700 Record Keeping Requirements

For each qualified employee, documentation should be kept showing the following:

- Employee name
- Date employee was hired
- Number of hours the employee worked for each month of employment
- Wage rate paid for each month of employment
- Schedule calculating the hiring credit
- Overtime hours
- Location where services were performed
- Date employee was terminated, and reason why

Section 9000 TARGETED TAX AREA SALE OR USE TAX CREDIT

References 17053.33; 23633

For each taxable year beginning on or after January 1, 1998, a qualified taxpayer engaged in a trade or business within a designated Targeted Tax Area (TTA) can take a credit for sales or use tax paid or incurred in connection with the purchase of qualified property.

The TTA sales or use tax credit applies to qualified property purchased after the designation date of the TTA.

- In any year, individuals may claim a credit equal to the sales or use tax paid or incurred on the purchase of the first $1 million of qualified property.
- In any year, corporations may claim a credit equal to the sales or use tax paid or incurred on the purchase of the first $20 million of qualified property. (See special rule for S corporations and shareholders in EDAM 8540).

No credit may be claimed for property purchased after the TTA designation expires, is revoked, is no longer binding, or becomes inoperative.

9100 Geographic Boundaries and Designation Date

For a listing of TTA cities, see "*TTA Locations and Designation Date*" EDAM 1340. To verify an address, refer to EDAM 1300.

9200 Exclusive Credit

References 17053.33(c); 23633(c)

If the TTA sales or use tax credit is claimed for the purchase of qualified property during the taxable year, no other credit is allowed with respect to that property.

9300 Qualified Taxpayer

References 17053.33(b)(2)(A); 23633(b)(2)(A)

EDAM 9310 Pass-Through Entities

A qualified taxpayer is a person or entity that is engaged in a trade or business within a TTA and whose trade or business is described in the following Standard Industrial Classification (SIC) Manual (1987 edition) code sections:

- Codes 2000 through 2099
- Codes 2200 through 3999
- Codes 4200 through 4299
- Codes 4500 through 4599
- Codes 4700 through 5199

9310 Pass-Through Entities

The determination of whether a taxpayer is a *qualified taxpayer* is made at the entity level. The term "pass-through entity" means any partnership or S corporation. The sales or use tax credit is allowed to the pass-through entity and passed through to the partners or shareholders.

9400 Qualified Property

References 17053.33(b)(1)(C); 17053.33(b)(1)(A); 23633(b)(1)(C); 23633(b)(1)(A)

EDAM 9410 Capitalized Requirement
EDAM 9420 Leased Property

Qualified property is used exclusively in the TTA and is defined as:

Machinery and machinery parts used for:

- Fabricating, processing, assembling, and manufacturing.
- The production of renewable energy resources.
- Air or water pollution control mechanisms.

Generally, qualified machinery parts include those parts that are necessary for the operation of the machinery (e.g., a conveyor belt).

Excluded parts are those used to complete a certain job. They are typically expensed to cost of good sold or general expense accounts. (e.g., specialized drill blades and oil utilized for routine maintenance work).

Effective for taxable years beginning on or after January 1, 1998, the definition of qualified property also includes:

- Data processing and communications equipment, such as computers, computer-automated drafting systems, copy machines, telephone systems, and fax machines; or
- Motion picture manufacturing equipment central to production and post-production, such as cameras, audio recorders, and digital image and sound processing equipment.

9410 Capitalized Requirement

References 17053.33(b)(1); 17053.33(f); 23633(b)(1); 23633(f)

Qualified property must be purchased and placed in service before the TTA expires, is no longer binding or becomes inoperative. Qualified property cost(s) are costs chargeable to a capital account (subject to depreciation) of the qualified taxpayer. If costs are expensed, rather than capitalized, no credit is allowed.

9420 Leased Property

Taxpayers who acquire property by lease arrangement may qualify for the sales or use tax credit. Lease arrangements structured using a financial (conditional sales) contract generally will qualify the taxpayer to take the sales or use tax credit. For reference sources to determine if a lease qualifies as a purchase rather than a lease arrangement, refer to IRS Revenue Ruling 55-540, 1955-2 C.B. 39, and FTB Legal Ruling 94-2, March 23, 1994.

9500 Credit Computation – Asset Value Limitation

References 17053.33(a); 17053.33(b)(1)(B); 23633(a); 23633(b)(1)(B)

EDAM 9510	Use Tax Paid on Qualified Property
EDAM 9520	Depreciable Basis
EDAM 9530	Business Income Activity Limitation
EDAM 9540	General Provisions – Apportionment of Business Income
EDAM 9541	Property Factor – Income Apportionment
EDAM 9542	Payroll Factor – Income Apportionment
EDAM 9543	Apportionment – Combined Groups
EDAM 9544	Apportioning for Personal Income Tax Taxpayers

The sales or use tax credit is equal to the amount of sales or use tax "paid or incurred" by the taxpayer in connection with the purchase and use of qualified property.

Example: Taxpayer spent $53,750 to purchase machinery used in the taxpayer's business within the TTA. The sales tax paid on the purchase is $3,750. The sales tax credit is $3,750.

Individuals, estates or trusts, partnerships, and limited liability companies (LLCs) taxed as partnerships may claim a credit on the sales or use tax paid or incurred to purchase up to $1 million of qualified property. Corporations may claim a credit on the sales or use tax paid or incurred to purchase up to $20 million of qualified property. This limitation applies to each taxable year. (See special rule for S corporations and shareholders in EDAM 8540).

NOTE: Upon acquisition, if the taxpayer/purchaser was exempt from paying sales tax on the property under the California Revenue & Taxation Code (CR&TC), then the taxpayer/purchaser did not pay or incur sales tax in connection with the purchase of the property to the extent of the exemption. Thus, the taxpayer/purchaser is not allowed to take the sales or use tax credit on the amount of the exemption.

9510 Use Tax Paid on Qualified Property

References 17053.33(d); 23633(d)

If a taxpayer, operating within a TTA, purchases property out of state and pays or incurs a use tax, the credit is allowed only if qualified property of a comparable quality and price is not timely available for purchase in this state.

9520 Depreciable Basis

References 17053.33(f); 23633(f)

Any taxpayer that elects to claim the sales or use tax credit, shall *not* increase the basis of the qualified property by the amount of the sales or use tax paid or incurred.

Example: Taxpayer spent $53,750 to purchase machinery used in the taxpayer's business within the TTA. The sales tax included in the purchase price was $3,750. The basis of the property is $50,000 ($53,750 less $3,750 sales tax).

9530 Business Income Activity Limitation

References 17053.33(g)(1); 23633(g)(1)

The amount of sales or use tax credit or hiring credit (see EDAM 9700) claimed, including any credit carryover from prior years, may not exceed the amount of tax on the TTA business income in any year. The TTA business income is that portion of the taxpayer's *California source* business income that is apportioned to the TTA. Non-business income or loss is not included in the calculation of business income from the TTA.

Example: Corp. A operates exclusively within the TTA. In order to determine the amount of sales or use tax credit allowable, the business income and the tax on that business income must be determined. Corp. A has the following items of income and expense:

Income from business operations	$30,000
Interest from investment which is unrelated to Corp. A's business operations	$2,000
Business expenses	(17,000)
Net Taxable Income	$15,000

Corp. A's income attributed to business operations is:

Income from business operations	$30,000
Business expenses	(17,000)
Net Business Income	$13,000

To determine the sales or use tax credit allowable, the net business income is multiplied by the current tax rate.

Net Business Income	$13,000
x 8.84%	x .0884
Tax associated with business income	$1,149

In this example, the taxpayer can offset the tax of $1,149 with the sales or use tax credit available (up to $1,149).

NOTE: "net tax"/"tax" and alternative minimum tax impose limitations on the allowable offset but were not considered a factor in this example.

9540 General Provisions – Apportionment of Business Income

References 17053.33(g)(1); 17053.33(g)(3)(B); 23633(g)(1); 23633(g)(3)(B)

If a business is located within and outside of a TTA, the taxpayer must determine the portion of the total business income that is attributable to each TTA.

- Business income is defined under the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA).
- Components of the factors are defined under the provisions of UDITPA.

For taxable years beginning on or after January 1, 1998, business income is apportioned to the TTA by multiplying the taxpayer's *California* source business income by a fraction, the numerator of which is the property factor plus the payroll factor, and the denominator of which is two (2).

9541 Property Factor – Income Apportionment

The property factor is a fraction. The numerator of the property factor is the average value of the real and tangible personal property owned or rented and used or available for use by the taxpayer *within the TTA* during the taxable year. The denominator is the average value of all real and tangible personal property owned or rented and used or available for use by the taxpayer during the taxable year *within California*.

Rented property is valued at 8 times the net annual rental rate. The net annual rental rate is the total rent paid for the property, less any subrental rates paid by subtenants.

9542 Payroll Factor – Income Apportionment

The payroll factor is a fraction. The numerator of the payroll factor is the total compensation paid to employees working for the taxpayer *within the TTA* during the taxable year. The denominator is the total compensation paid to employees working for the taxpayer *within California* during the taxable year.

Example: Corp. A operates within and outside a TTA. California business income of $13,000 needs to be apportioned to the TTA. The following amounts apply to Corp. A's property and payroll:

TTA Property	$40,000
CA Property	$100,000
TTA Payroll	$5,000
CA Payroll	$10,000

TTA Property/CA Property	=. 40	
TTA Payroll/CA Payroll	=. 50	
	.90/2 = .45	TTA Apportionment Factor

Business income	$13,000
Apportionment Factor	x 0.45
TTA Business Income	$5,850
Current Tax Rate	x .0884
Tax attributable to TTA business income	$517

9543 Apportionment – Combined Groups

For members of a combined group, the limitation will be based on the intrastate apportioned business income for each taxpayer doing business within the TTA. The numerator of the apportionment formula will be based on each TTA taxpayer's separate TTA property and payroll amounts and the denominator will be based on each TTA taxpayer's separate California property and payroll amounts.

Example: For the taxable year ended 12/31/2001, Parent Corporation A has two subsidiaries, B and C. Corporations A and B operate within the TTA. The combined group operates within and outside California and apportions its income to California using Schedule R. The combined group's business income apportioned to California was $1,000,000. Corporation A and B's share of California business income is $228,000 and $250,000 respectively. Corporation A and B's separate TTA and separate California property and payroll factor amounts are shown below.

Business income apportioned to the TTA was determined as follows:

	A	B
<u>Property Factor</u>		
TTA Property	$1,000,000	$ 800,000
California Property	$1,000,000	$1,200,000
Apportionment %	100%	66.66%
<u>Payroll Factor</u>		
TTA Payroll	$800,000	$ 800,000
California Payroll	$800,000	$1,000,000
Apportionment %	100%	80%
Average Apport. % (Property + Payroll Factors)/2	100%	73.33%
Apportioned Business Income	$228,000	$250,000
TTA Income	$228,000	$183,333

9544 Apportioning for Personal Income Tax Taxpayers

The following examples show the application of the apportioning rules to personal income tax taxpayers.

Example: Ray Smith is vice president of an S corporation that has two locations, one within a TTA and one outside the TTA. Eighty percent (80%) of the S corporation's business is attributable to the TTA. (**NOTE**: This percentage was determined by the S corporation, using Worksheet IV from the FTB 3809 Business Booklet, at the time the S corporation return was prepared). Ray divides his time equally (50% & 50%) between the two offices of the S corporation.

Mary Smith (Ray's spouse) works for the S corporation at its office located in the TTA.

Ray and Mary Smith have the following 1999 items of California income and expense:

Ray's salary from the S corp.	$100,000
Mary's salary from the S corp.	75,000
Interest on savings account	1,000
Dividends	3,000
Schedule K-1(100S) from the S corp.	
Ordinary income	40,000
TTA business expense deduction	(5,000)*
Ray's unreimbursed employee expenses from Schedule A	(2,000)

*The TTA business expense deduction is a separately stated item on Schedule K-1 (100S).

The Smith's TTA income is computed as follows:

Ray's TTA salary ($100,000 x 50%)	$50,000
Mary's TTA salary ($75,000 x 100%)	75,000
Pass-through ordinary income from the S-Corp. ($40,000 x 80%)	32,000
TTA business expense deduction from the S-Corp.	(5,000)
Ray's unreimbursed employee business expenses (2,000 x 50%)	(1,000)
Total TTA income	$151,000

Ray and Mary must compute the tax on the total TTA income of $151,000 (as if it represents all of their income). Using the tax rate schedule for the filing status *married* *filing joint*; the 1999 tax on $151,000 is $10,659. The $10,659 is the first limitation on TTA credits for the 1999 taxable year. The second limitation on the credits is the *net tax* on all income.

NOTE: The standard deduction and personal or dependency exemptions are not included in the computation of TTA income since they are not related to trade or business activities.

9600 S Corporation & Shareholder Credit Amounts

References 17053.33(b)(1)(B); 17053.33(b)(2)(B); 23633(b)(1)(B); 23633(b)(2)(B); 23803

S corporations operating within a TTA may claim a credit on the sales or use tax paid or incurred to purchase up to $20 million of qualified property. This limitation applies to each taxable year. The S corporation may only use one-third (1/3) of the credit to reduce the tax on the S corporation's TTA income.

An S corporation's sales or use tax credit may reduce the TTA tax at both the corporate and shareholder levels. One hundred percent (100%) of the TTA credits are passed through to the S corporation shareholders. However, S corporation shareholders are only allowed to claim a credit on the sales or use tax paid or incurred on the purchase of up to $1 million of qualified property of the S corporation for each taxable year. The shareholders claim their pro-rata share of this credit as recomputed under the California personal income tax law (Part 10).

The sales or use tax credit is first computed for the S corporation using the actual qualified acquisition costs not to exceed $20 million. The amount of credit passing through to the shareholders is then computed using the actual qualified acquisition costs not to exceed $1 million. This credit based on the $1 million limitation is passed through to the shareholders based on their pro rata share. The Schedules K (100S) and K-1 (100S) must state the credit amounts allocable to the shareholders.

Example: Corp. Z, an S corporation, purchases $2 million of qualified property, and takes the TTA sales or use tax credit. Corp. Z is allowed to claim a sales or use tax credit of $50,000 ($2,000,000 x 7.5% x 1/3 = $50,000). [Cost (not to exceed $20,000,000) x sales tax rate x 1/3 S corporation credit limitation]

The corporation's two shareholders allocate between them a sales or use tax credit of $75,000 ($1,000,000 x 7.5% = $75,000). [Cost (not to exceed $1,000,000) x sales tax rate]

NOTE: The State Board of Equalization in an unpublished (non-citable) decision, concluded that the $20 million limitation applied to the S-Corp and the $1 million limitation applied collectively to the S-Corp shareholders. *Appeal of Barry and Wendy Breslow,* Cal. St. Bd. Of Equal., November 6, 2001.

9700 Sales Or Use Tax Credit And The Hiring Credit

References 17053.33(g)(1); 23633(g)(1)

The amount of credit(s) allowed, in any taxable year, when a taxpayer is eligible to take both the sales or use tax credit and the hiring credit, is limited to the amount of tax imposed on the TTA business income. Thus, the taxpayer must aggregate the credits and limit the total amount of credits to tax imposed on the TTA business income.

9800 Credit Usage and Carryover

References 17053.33(e), 17053.33(g)(1); 23633(e); 23633(g)(1)

EDAM 9810	Credit Will Not Reduce Certain Taxes
EDAM 9820	Depreciation
EDAM 9830	Credit Recapture

The portion of the credit that exceeds the "net tax"/"tax" for the taxable year, is carried over and added to the credit, if any, in the following year. The credit is carried over to succeeding years, until it is exhausted.

The aggregate amount of the TTA credits, including any credit carryover from prior years, that may reduce the "net tax"/"tax" for the taxable year, shall not exceed the amount of tax imposed on the taxpayer's business income attributable to the TTA, determined as if that income represented all of the income of the taxpayer.

Example: A taxpayer has $4,900 in TTA credits (sales or use tax credit *and* hiring credit). Tax imposed on TTA business income is $4,700 and the taxpayer's overall "net tax"/"tax" is $4,000. The maximum amount of credit is limited to the lesser of the tax on the TTA business income, or the tax on the taxpayer's overall "net tax"/"tax".

Total TTA credit	$4,900
Tax on TTA income	$4,700
First limitation:	
Lesser of total credit or tax on TTA income	$4,700
Second limitation:	
Lesser of tax on TTA income or "*net tax*"/"*tax*"	$4,000
Maximum credit allowed:	
Lesser of *TTA tax limitation* or "*net tax*"/"*tax*" *limitation*	$4,000
Total TTA credit	$4,900
Maximum credit allowed	$4,000
Carryover	$ 900

In the event that a credit carryover is allowable for any taxable year after the TTA designation expires, is revoked, is no longer binding, or becomes inoperative, the TTA is deemed to remain in existence for the purpose of computing the business income limitation.

9810 Credit Will Not Reduce Certain Taxes

The TTA sales or use tax credit cannot reduce the:

- Minimum franchise tax (corporations, limited partnerships, limited liability partnerships, LLCs, and S corporations);
- Annual tax (partnerships, LLCs classified as partnerships, and Qsubs);
- Built-in gains tax (S corporations);
- Excess net passive income tax (S corporation); or
- Alternative minimum tax (corporations, exempt organizations, individuals and fiduciaries).

The TTA sales or use tax credit may however reduce regular tax below tentative minimum tax.

9820 Depreciation

References 17053.33(f); 23633(f); 18036; 17267.6(f); 24356.6(e); 24916

Taxpayers electing to utilize the sales or use tax credit are not entitled to increase the basis of the property for which sales or use tax was paid or incurred in connection with the purchase of the property.

Depreciation of the capitalized cost of the asset may be claimed using any method of depreciation allowable beginning in the year the asset is placed in service.

NOTE: If the business expense deduction is taken for the same property, depreciation will start with the taxable year following the year in which the property is placed in service. The depreciation is calculated on the remaining basis *after* reduction for the sales or use tax credit and business expense deduction amounts.

9830 Credit Recapture

There are no recapture provisions for the TTA sales or use tax credit.

9900 Record Keeping Requirements

To support the sales or use tax credit claimed, the taxpayer must keep all records that document the purchase of the qualified property and payment of sales or use tax. This includes items such as purchase receipts and proof of payment. In addition, taxpayers should keep all records that identify or describe:

- The property purchased (such as serial numbers, etc.);
- The amount of sales or use tax paid or incurred upon purchase;
- The location where the property is used;
- Sales or Use Tax Returns filed with the Board of Equalization;
- Audit reports issued by the Board of Equalization for audits related to use tax paid, or fixed asset audits; and
- If purchased from a manufacturer located outside California, records to substantiate that property of comparable quality and price was not available for purchase in California.

Section 10000 TARGETED TAX AREA BUSINESS EXPENSE DEDUCTION

References 17267.6(a); 24356.6(a)

For each taxable year beginning on or after January 1, 1998, a person or entity engaged in a trade or business within a Targeted Tax Area (TTA) may elect to treat 40% of the eligible cost of qualified property as a business expense rather than a capital expense.

The deduction is allowed for the taxable year in which the property is placed in service.

10100 Geographic Boundaries and Designation Date

For a listing of TTA cities, see "*TTA Locations and Designation Date*" EDAM 1340. To verify an address, refer to EDAM 1300.

10200 Qualified Taxpayer

References 17267.6(e)(1)(B); 24356.6(d)(1)(B)

EDAM 10210 Estates and Trusts
EDAM 10220 Pass-Through Entities

A qualified taxpayer is a person or entity engaged in a trade or business within the TTA and whose trade or business is described in the following Standard Industrial Classification (SIC) Manual (1987 edition) code sections:

- Codes 2000 through 2099
- Codes 2200 through 3999
- Codes 4200 through 4299
- Codes 4500 through 4599
- Codes 4700 through 5199

10210 Estates and Trusts

References 17267.6(d)(4)

Estates and trusts are not allowed to take the business expense deduction.

10220 Pass-Through Entities

The determination of whether a taxpayer is a qualified taxpayer is made at the entity level. The term "pass-through entity" means any partnership or S corporation. The business expense deduction is allowed to the pass-through entity and passed through to the partners or shareholders.

10300 Qualified Property

References 17267.6(d)(1); 24356.6(c)(1)

EDAM 10310 Leased Property
EDAM 10320 Property Not Qualified

Qualified property is IRC § 1245 property (as defined in IRC § 1245(a)(3)) purchased and placed in service for exclusive use in a trade or business conducted within the TTA. The property must also be purchased and placed in service before the date the TTA designation expires, is revoked, is no longer binding, or becomes inoperative.

Qualified property under IRC § 1245 includes, but is not limited to, tangible personal property (excluding buildings and inventory) that is subject to the allowance for depreciation. This includes most equipment and furnishings purchased for exclusive use within the TTA. Office supplies and other small non-depreciable items are not included.

10310 Leased Property

Taxpayers who acquire property by lease arrangement may be able to take the business expense deduction. The structure of the leasing arrangement itself is critical. Lease arrangements structured using a financial (conditional sales) contract generally will qualify the taxpayer to take the business expense deduction. For reference sources to determine if a lease qualifies as a purchase rather than a lease arrangement, refer to IRS Revenue Ruling 55-540, 1955-2 C.B. 39, and FTB Legal Ruling 94-2, March 23, 1994.

10320 Property Not Qualified

References 17267.6(d)(1); 17267.6(d)(2); 17267.6(d)(5); 24356.6(c)(1); 24356.6(c)(2); 24356.6(c)(4)

The business expense deduction is not allowed if the property:

- Was transferred between members of an affiliated group;
- Was acquired as a gift or inherited;
- Was traded for other property;
- Was received from a personal or business relation as defined by IRC § 267, as modified by CR&TC § 17267.6(d)(2)(A) and § 24356.6(c)(2)(A) for the TTA;
- Was received from a personal or business relation as defined by IRC § 707(b); or
- Is described in IRC § 168(f).

10400 Deduction Amount

References 17267.6(g); 24356.6(f)

EDAM 10410 Pass-Through Entities
EDAM 10420 Personal Income Tax Taxpayers-Married Filing Separate
EDAM 10430 Basis Reduction/Depreciation
EDAM 10440 Interaction with the Manufacturer's Investment Credit
EDAM 10450 Recapture

The maximum *deduction* the taxpayer may claim in any taxable year is determined by the number of years that have elapsed since the area was designated, as follows:

Taxable Years	Maximum Aggregate Cost	Maximum Deduction
Taxable year of designation and 1st year thereafter	$100,000	$40,000
2nd and 3rd taxable year thereafter	$75,000	$30,000
Each taxable year thereafter	$50,000	$20,000

10410 Pass-Through Entities

References 17267.6(d)(6)

In the case of pass-through entities, the percentage limitation (40%), of the aggregate cost of all qualified property, shall apply at the entity level and at the partner/shareholder level.

10420 Personal Income Tax Taxpayers-Married Filing Separate

References 17267.6(b)

In the case of a husband and wife filing separate returns for a taxable year, the applicable deduction is equal to one-half (50%) of the otherwise allowable deduction.

10430 Basis Reduction/Depreciation

The basis (cost for depreciation purposes) of the property is reduced by the amount allowed as a deduction. Depreciation of the cost of the property, less the amount deducted, is claimed using any method of depreciation normally allowed, beginning with the taxable year following the year in which the property is placed in service.

Taxpayers electing to take the business expense deduction cannot claim the additional first year depreciation (IRC § 179) for the same property.

10440 Interaction with the Manufacturer's Investment Credit

References 17053.49(b)(1)(C); 23649(b)(1)(C)

Taxpayers claiming the business expense deduction and the Manufacturers' Investment Credit (MIC) for the same property must reduce MIC qualified costs by the amount of the business expense deduction before computing the MIC. Taxpayers that elect to take the business expense deduction are not allowed to capitalize the expensed amount.

10450 Recapture

References 17267.6(h); 24356.6(g)

The business expense deduction is subject to recapture (added back to income) if, before the *close of the second taxable year after* the property is placed in service, the property is sold, disposed of or is no longer used exclusively within the TTA trade or business. The taxpayer is required to recapture the amount previously expensed for that item and shall include that amount as income for the taxable year in which the property ceases to be used. The basis of the property is increased as of the first day of the taxable year in which the recapture event occurs. (See Cal. Code Regs. (CCR) § 17267.2 or 24356.7 as it pertains to Enterprise Zones.)

Example: Corp. A purchases property on June 1, 1998, which qualifies Corp. A to take the TTA business expense deduction. Corp. A's taxable year ends December 31 of each year. Corp. A disposes of the property August 5, 2000. The previous deduction is added to income in the 2000 taxable year because the property was disposed of before the close of the second taxable year after the property was placed in service, 12/31/2000. The basis in the asset is increased by the recaptured amount effective January 1, 2000.

NOTE: The State Board of Equalization in an unpublished (uncitable) decision agreed that the statute requires the closure of two taxable years after the end of the taxable year in which the property is placed in service and the election to claim the deduction on the original return is made. *Appeal of Accurate Metal Fabricators, Inc., 32552, Cal.* St. Bd. Of Equal., July 3, 2000.

10500 Making the Election

References 17267.6(a); 17267.6(c); 24356.6(a); 24356.6(b)

EDAM 10510 Members of an Affiliated Group

The taxpayer must make an election to treat the cost of qualified property as a business expense on the original return filed for the taxable year the property is first placed in service. The election must specify the items to which the election applies and the portion of the cost taken into account for purposes of determining the deduction amount.

A taxpayer makes an election by filing:

- Form FTB 3809 – Targeted Tax Area Deduction and Credit Summary.

The election may not be revoked, unless the taxpayer has obtained the consent of the Franchise Tax Board.

10510 Members of an Affiliated Group

References 24356.6(c)(5)-(6)

For purposes of electing the business expense deduction, all members of an affiliated group shall be treated as one taxpayer. The maximum deduction amount shall be properly apportioned among the members of the affiliated group.

An affiliated group is defined in IRC § 1504 as modified by the California Revenue & Taxation Code, to replace "at least 80%" with "more than 50%" each place it appears in IRC § 1504(a).

10600 Creating a Net Operating Loss

Unlike IRC § 179, there is *no* statutory prohibition on the amount of business expense deduction that may create a net operating loss.

10700 Alternative Minimum Tax

References 17062; 23457

The business expense deduction is *not* listed as a tax preference item.

10800 Checklist To Determine Eligibility for the Business Expense Deduction

Checklist Items	Yes	No
Is the business qualified? • Does the business meet the applicable code section classification as described in the Standard Industrial Classification (SIC) Manual (1987 edition)? See the *Qualified Taxpayer* section (EDAM 8200).		
Is the property qualified? • Qualified property is IRC § 1245 property. See the *Qualified Property* section (EDAM 10300). • Is the property used exclusively within the boundaries of the TTA?		
Is the correct deduction amount claimed? • Limitation differs based on year of designation. See *Deduction Amount* section (EDAM 10400). • Verify purchase on invoices or receipts. • Verify the date the property is placed in service.		
Was a timely election made? • Election made on original return? • Form FTB 3809 – Targeted Tax Area Deduction and Credit Summary, or a separate statement attached to the return?		
Was the property acquired through a valid transaction? • See the *Property Not Qualified* section (EDAM 10320).		
Was correct depreciation claimed? • Basis must be reduced by the amount of the business expense deduction before depreciation is computed. • IRC § 179 expense or additional first year depreciation may not be claimed for qualified property for which the business expense deduction is claimed. • A depreciation deduction on qualified property is not allowed in the same year the business expense deduction is claimed.		
Is the deduction subject to recapture? • Was the property sold, disposed of or no longer used by the taxpayer in the area, before the close of the second taxable year after the property was placed in service? • Check current location of the qualified property. • Check sale or disposal date of qualified property.		

10900 Record Keeping Requirements

To support the business expense deduction claimed, the taxpayer must keep all records that document the purchase of the qualified property. This includes items such as purchase receipts and proof of payment. In addition, taxpayers should keep all records that identify or describe:

- The property purchased (such as serial numbers, etc.); and
- The location where the property is used

Section 11000 TARGETED TAX AREA NET OPERATING LOSS

References 17276.1(a); 17276.6(a); 24416.1(a); 24416.6(a)

Taxpayers are required to annually report their income and expenses. Due to possible fluctuations in income and expenses, a taxpayer may have substantial profits in one year, while losses in another. In years where expenses exceed income, a net operating loss (NOL) occurs.

A qualified taxpayer engaged in a trade or business within the designated Targeted Tax Area (TTA) may elect to carry forward 100% of its NOLs for a 15 year period.

A TTA NOL cannot be generated until the first taxable year beginning on or after the official TTA designation date (November 1, 1998).

11100 Geographic Boundaries and Designation Date

For a listing of TTA cities, see "*TTA Locations and Designation Date*" EDAM 1340. To verify an address, refer to EDAM1300.

11200 Qualified Taxpayer

References 17276.6(a)(1)-(2); 24416.6(a)(1)-(2)

EDAM 11210 Pass-Through Entities
EDAM 11211 S Corporations

For purposes of the TTA NOL deduction, a qualified taxpayer includes a person or entity engaged in a trade or business within the TTA, and is described in the following Standard Industrial Classification (SIC) Manual (1987 edition) code sections:

- Codes 2000 through 2099
- Codes 2200 through 3999
- Codes 4200 through 4299
- Codes 4500 through 4599
- Codes 4700 through 5199

Taxpayers doing business in an area that was previously *not* a qualified area, but later designated as qualified, are allowed to utilize the special tax incentives for the taxable year beginning on or after the date the area receives its TTA designation.

11210 Pass-Through Entities

References 17087.5; 17087.6; 17276.6(a)(2); 17851; 23800; 24271; 24416.6(a)(2)

In the case of any "pass-through entity", the determination of whether a taxpayer is a qualified taxpayer is made at the entity level.

The income and loss that will flow through to a shareholder, beneficiary, partner, or member, retains the same characteristics as it had with the pass-through entity.

The election to claim an NOL (see EDAM 11300) is made by the entity and each investor on their respective returns. The election by the entity to utilize the TTA NOL does not extend to, or bind the investor to utilizing the TTA NOL. Further, the investor may utilize the TTA NOL if the entity utilized the general NOL provisions, or had no NOL. Each taxpayer must determine if they in fact have a NOL, and then decide whether to utilize the general or TTA NOL.

11211 S Corporations

References 23802(d)(1)-(2)

For qualified taxpayers electing S corporation status *after* the designation of the TTA, the qualified NOL attributed to the C corporation years cannot offset S corporation net income.

11300 Making the Election

References 17276.1(b); 17276.6(c); 24416.1(c); 24416.6(c)

Qualified taxpayers must make an election to claim the TTA NOL. The election must be timely filed with the original return, and be for the taxable year in which the NOL is incurred. The election is irrevocable.

If the taxpayer is eligible to qualify for an NOL under more than one section (operation in more than one economic development area, new small business etc.), the taxpayer must choose which section to elect. Except for the loss incurred under the subdivision elected, taxpayers are prohibited from carrying over any other type of NOL from the same taxable year.

Failure to elect to compute the NOL deduction under CR&TC § 17276.1 or 24416.1 will cause the NOL to be subject to the limitations and restrictions under CR&TC § 17276 or 24416 (general NOL).

A taxpayer makes the election by filing:

- Form FTB 3809 – Targeted Tax Area Deduction and Credit Summary.

In addition, the form FTB 3809 must be filed for each year in which the NOL deduction is taken.

11400 TTA NOL Computation - General Provisions

References 17276.1; 17276.6(b)(2); 24416.1; 24416.6(b)(2)

EDAM 11410 TTA NOL Limited by General NOL

A TTA NOL is the loss attributable to the qualified taxpayer's business activities within the TTA, prior to the TTA expiration date. TTA NOLs are determined under IRC § 172, as modified by California Revenue & Taxation Code Sections 17276.1, 17276.6, 24416.1, and 24416.6

11410 TTA NOL Limited by General NOL

References 17276; 24416

The TTA NOL, as computed under EDAM 11500, is compared to the NOL computed under the general NOL provisions of CR&TC §17276 / 24416, prior to the 50% reduction. The TTA NOL carryover is limited to the lesser of the TTA NOL or the general NOL (prior to the 50% reduction). **NOTE**: If the TTA NOL is limited by the general NOL amount, (prior to the 50% reduction), the amount can still be characterized as an TTA NOL and allowed to be carried over at 100% for 15 years. An election must be made to characterize the NOL as a TTA NOL.

Example: Corp. B incurred the following loss:

Income from business operations	$160,000
Interest from investment which is unrelated to Corp. B's business operations	15,000
Expenses of business operations	(189,000)
Net loss	*($14,000)*

To determine the NOL carryover attributed to the TTA business operations, the following must be done:

- Determine NOL per CR&TC §24416 (prior to 50% reduction)
- Determine NOL per CR&TC §24416.6 (remove non-business items)

The NOL carryover is limited to the lesser of item 1 or item 2 above.

CR&TC § 24416 "general" NOL - prior to 50% reduction

Net loss of Corp. B	($14,000)

CR&TC § 24416.6 TTA NOL - exclude non-business income/loss

Income from operations	$160,000
Expenses of operations	(189,000)
Net loss of Corp. B (TTA)	($29,000)

Pattern 1: Assume Corp. B operates entirely within the TTA. Corp. B is allowed to carry over the lesser of the "general" NOL, or the TTA NOL; in this case $14,000.

Pattern 2: Assume Corp. B conducts 40% of its total business operations in the TTA, as computed under EDAM 11500. Because Corp. B only has 40% of its business operation in the TTA, the $29,000 business loss must be apportioned before comparing it to the "general" NOL. In this example, the TTA loss is $11,600 ($29,000 x 40%). Corp. B is allowed to carry over the lesser of the "general" NOL, or the TTA NOL; in this case, $11,600.

11500 TTA NOL - Loss Attributed to Business Activity

References 17276.6(b)(2); 24416.6(b)(2)

EDAM 11510	Property Factor – Loss Apportionment
EDAM 11520	Payroll Factor – Loss Apportionment
EDAM 11530	Apportionment – Combined Groups
EDAM 11540	Apportioning for Personal Income Tax Taxpayers

A TTA NOL is the loss attributable to the qualified taxpayer's business activities within the TTA prior to the TTA expiration date. Non-business income and/or loss are excluded from the calculation of the TTA NOL.

If a business is located within and outside of the TTA, the taxpayer must determine the portion of the total business loss attributable to the TTA.

- Business loss is defined under the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA).
- Components of the factors are defined under the provisions of UDITPA.

For taxpayers conducting business operations within and without a TTA, business loss is apportioned to the TTA by multiplying the worldwide business loss by a fraction, the numerator of which is the property factor plus the payroll factor, and the denominator of which is two (2).

11510 Property Factor – Loss Apportionment

The property factor is a fraction.

- The numerator of the property factor is the average value of the real and tangible personal property owned or rented and used or available for use by the taxpayer *within the TTA* during the taxable year.
- The denominator is the average value of all real and tangible personal property owned or rented and used or available for use during the taxable year *worldwide*.

Rented property is valued at eight (8) times the net annual rental rate. The net annual rental rate is the total rent paid for the property, less any subrental rates paid by subtenants.

11520 Payroll Factor – Loss Apportionment

The payroll factor is a fraction.

- The numerator of the payroll factor is the total compensation paid to the taxpayer's employees working within the TTA during the taxable year.
- The denominator is the total compensation paid to employees working *worldwide* during the taxable year.

Example - Two-factor apportionment: For the taxable year 12/31/99, Corp. A operates within and outside a TTA. Corp. A's business loss of $13,000 needs to be apportioned to the TTA. The following amounts apply to Corp. A's property and payroll:

TTA Property	$40,000
Worldwide (WW) Property	$100,000
TTA Payroll	$5,000
WW Payroll	$10,000

TTA Property/WW Property	=.40	
TTA Payroll/WW Payroll	=.50	
	.90/2 = .45	TTA Apportionment Factor

Business loss	$(13,000)
Apportionment Factor	x 0.45
TTA NOL	$(5,850)

11530 Apportionment – Combined Groups

For members of a combined group, the TTA NOL calculation will be based on the combined groups worldwide business loss (before CA apportionment). The numerator of the apportionment formula will be based on each TTA taxpayer's separate TTA payroll and property amounts, and the denominator will be based on the combined groups worldwide payroll and property amounts.

Example: For the taxable year ending 12/31/99, Parent Corporation A has two subsidiaries, B and C. Corporations A and B operate within a TTA. The combined group operates within and outside California and apportions its income or loss to California using Schedule R. The combined group's business loss is $1,000,000.

Business loss apportioned to the TTA was determined as follows:

	A	**B**	**C**	**Combined**
Property Factor				
TTA Property	$2,000,000	$1,000,000	$0	$3,000,000
Worldwide Property				$5,000,000
Apportionment %	40%	20%		60%
Payroll Factor				
TTA Payroll	$2,000,000	$800,000	$0	$2,800,000
Worldwide Payroll				$4,000,000
Apportionment %	50%	20%		70%
Average Apport. % (Property + Payroll Factors)/2	45%	20%		65%
Business Loss				$(1,000,000)
TTA NOL	$(450,000)	$(200,000)		$(650,000)

11540 Apportioning for Personal Income Tax Taxpayers

The following examples show the application of the apportioning rules to personal income tax taxpayers.

Example: Ray Smith is vice president of an S corporation that has two locations, one within a TTA and one outside the TTA. Eighty percent (80%) of the S corporation's business is attributable to the TTA. (**NOTE**: This percentage was determined by the S corporation, using Worksheet V from the FTB 3809 Business Booklet, at the time the S corporation return was prepared). Ray divides his time equally (50% & 50%) between the two offices of the S corporation.

Mary Smith (Ray's spouse) works for the S corporation at its office located in the TTA.

Ray and Mary Smith have the following 1999 items of California income and expense:

Ray's salary from the S corp.	$100,000
Mary's salary from the S corp.	75,000
Interest on savings account	1,000
Dividends	3,000
Schedule K-1(100S) from the S corp.	
Ordinary Loss	200,000
TTA business expense deduction	(5,000)*
Ray's unreimbursed employee expenses from Schedule A	(2,000)

*The TTA business expense deduction is a separately stated item on Schedule K-1 (100S).

The Smith's TTA loss is computed as follows:

Ray's TTA salary ($100,000 x 50%)	$50,000
Mary's TTA salary ($75,000 x 100%)	75,000
Pass-through ordinary loss from the S-Corp. ($200,000 x 80%)	(160,000)
TTA business expense deduction from the S-Corp.	(5,000)
Ray's unreimbursed employee business expenses (2,000 x 50%)	(1,000)
Total TTA loss	$(41,000)

NOTE: The standard deduction and personal or dependency exemptions are not included in the computation of TTA NOL since they are not related to trade or business activities.

11600 Carryover / Carryback

References 17276.1(a); 17276.6(b)(1) – (2); 17276.6(e); 24416.1(a); 24416.1(a)(3); 24416.6(b)(1) - (2); 24416.6(f)

For each taxable year beginning on or after January 1, 1998, a qualified taxpayer engaged in a trade or business within the designated TTA may elect to carryover 100% of its NOL. No NOL carrybacks are allowed.

The NOLs may be carried over to each of the 15 taxable years following the year of loss, or until exhausted, whichever occurs first. If an NOL carryover remains after the TTA designation has expired, the TTA is deemed to remain in existence for purposes of computing the TTA income limitation, and for purposes of allowing the TTA NOL deduction.

NOTE: Financial institutions. As defined in IRC § 585, 586, or 593, using bad debt reserve methods may carry the loss forward for a maximum of 5 taxable years.

11700 TTA NOL Deduction - General Provisions

References 17276.6(b)(3); 17276.6(b)(4); 24416.6(b)(3); 24416.6(b)(4)

EDAM 11710 Business Income Activity Limitation
EDAM 11711 Property Factor – Income Apportionment
EDAM 11712 Payroll Factor – Income Apportionment
EDAM 11713 Apportionment – Combined Groups
EDAM 11714 Apportioning for Personal Income Tax Taxpayers

The TTA NOL carryover can only *offset business income attributable to operations of the taxpayer within the designated TTA*.

In the event that a TTA NOL carryover is allowable for any taxable year after the TTA designation expires, is revoked, is no longer binding, or becomes inoperative, the TTA is deemed to remain in existence for the purpose of computing the business income limitation and allowing a TTA NOL deduction.

11710 Business Income Activity Limitation

References 17276.6(b)(4); 17276.6(b)(4)(A); 24416.6(b)(4); 24416.6(b)(4)(A)

If a business is located within and outside of the TTA, the taxpayer must determine the portion of the total business income that is attributable to the TTA.

- Business income is defined under the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA).
- Components of the factors are defined under the provisions of UDITPA.

Business income is apportioned to the TTA by multiplying the taxpayer's total California source business income by a fraction, the numerator of which is the property factor plus the payroll factor, and the denominator of which is two (2).

11711 Property Factor – Income Apportionment

The property factor is a fraction.

- The numerator of the property factor is the average value of the real and tangible personal property owned or rented and used or available for use by the taxpayer *within the TTA* during the taxable year.
- The denominator is the average value of all real and tangible personal property owned or rented and used or available for use by the taxpayer during the taxable year *within California*.

Rented property is valued at eight (8) times the net annual rental rate. The net annual rental rate is the total rent paid for the property, less any subrental rates paid by subtenants.

11712 Payroll Factor – Income Apportionment

The payroll factor is a fraction.

- The numerator of the payroll factor is the total compensation paid to the taxpayer's employees working within the TTA during the taxable year.
- The denominator is the total compensation paid to employees working for the taxpayer *in California* during the taxable year.

Example: Corp. A operates within and outside the TTA. California business income of $13,000 needs to be apportioned to the TTA. The following amounts apply to Corp. A's property and payroll:

TTA Property	$40,000
CA Property	$100,000
TTA Payroll	$5,000
CA Payroll	$10,000

TTA Property/CA Property	=.40	
TTA Payroll/CA Payroll	=.50	
	.90/2 = .45	TTA Apportionment Factor

Business income	$13,000
Apportionment Factor	x 0.45
TTA Business Income	$5,850

11713 Apportionment – Combined Groups

For members of a combined group, the limitation is based on the intrastate apportioned business income for each taxpayer doing business within the TTA. The numerator of the apportionment formula is based on each TTA taxpayer's separate TTA property and payroll amounts and the denominator will be based on each TTA taxpayer's separate California property and payroll amounts.

Example: For taxable year ending 12/31/99, parent corporation A has two subsidiaries, B and C. Corporations A and B operate within the TTA. The combined group operates within and outside California and apportions its income to California using Schedule R. The combined group's business income apportioned to California was $1,000,000. Corporation A and B's share of California business income is $228,000 and $250,000 respectively. Corporation A and B's separate TTA and separate California property and payroll factor amounts are shown below.

Business income apportioned to the TTA was determined as follows:

	A	B
<u>Property Factor</u>		
TTA Property	$1,000,000	$ 800,000
California Property	$1,000,000	$1,200,000
Apportionment %	100%	66.66%
<u>Payroll Factor</u>		
TTA Payroll	$800,000	$ 800,000
California Payroll	$800,000	$1,000,000
Apportionment %	100%	80%
Average Apport. %	100%	73.33%
(Property + Payroll Factors)/2		
Apportioned		
Business Income	$228,000	$250,000
TTA Income	$228,000	$183,333

11714 Apportioning for Personal Income Tax Taxpayers

The following examples show the application of the apportioning rules to personal income tax taxpayers.

Example: Ray Smith is vice president of an S corporation that has two locations, one within a TTA and one outside the TTA. Eighty percent (80%) of the S corporation's business is attributable to the TTA. (**NOTE**: This percentage was determined by the S corporation, using Worksheet V from the FTB 3809 Business Booklet, at the time the S corporation return was prepared). Ray divides his time equally (50% & 50%) between the two offices of the S corporation.

Mary Smith (Ray's spouse) works for the S corporation at its office located in the TTA.

Ray and Mary Smith have the following 1999 items of California income and expense:

Ray's salary from the S corp.	$100,000
Mary's salary from the S corp.	75,000
Interest on savings account	1,000
Dividends	3,000
Schedule K-1(100S) from the S corp.	
Ordinary income	40,000
TTA business expense deduction	(5,000)*
Ray's unreimbursed employee expenses from Schedule A	(2,000)

*The TTA business expense deduction is a separately stated item on Schedule K-1 (100S).

The Smith's TTA income is computed as follows:

Ray's TTA salary ($100,000 x 50%)	$50,000
Mary's TTA salary ($75,000 x 100%)	75,000
Pass-through ordinary income from the S-Corp. ($40,000 x 80%)	32,000
TTA business expense deduction from the S-Corp.	(5,000)
Ray's unreimbursed employee business expenses (2,000 x 50%)	(1,000)
Total TTA income	$151,000

NOTE: The standard deduction and personal or dependency exemptions are not included in the computation of TTA income since they are not related to trade or business activities.

11800 NOL Suspensions

References 17276.3(c); 24416.3(c)

For taxable years beginning in 2002 and 2003, California suspended the Net Operating Loss (NOL) carryover deduction. Taxpayers may continue to compute and carryover an NOL during the suspension period. The carryover period for suspended losses is extended by two years for losses incurred before January 1, 2002 and by one year for losses incurred after January 1, 2002 and before January 1, 2003. The deduction for disaster losses is not affected by the NOL suspension rules.

11900 Alternative Minimum Tax

References 17062; 23456

Taxpayers claiming a TTA NOL deduction must also determine their NOL for alternative minimum tax purposes.

Section 12000 LOCAL AGENCY MILITARY BASE RECOVERY AREA HIRING CREDIT

References 17053.46(a); 17053.46(b)(4)(B); 23646(a); 23646(b)(4)(B)

For each taxable year beginning on or after January 1, 1995, the California Revenue and Taxation Code (CR&TC) provides a hiring credit for "qualified taxpayers" who operate or invest in a business located within a designated Local Agency Military Base Recovery Area (LAMBRA) and hire "qualified employees" and pay them "qualified wages". LAMBRAs were established in California to stimulate development in areas that experience military base closures.

The LAMBRA hiring credit applies to those employees hired after the designation date of the LAMBRA.

12100 Geographic Boundaries and Designation Dates

For a listing of LAMBRAs, see "*LAMBRA Locations and Designation Dates*" EDAM 1320. To verify an address, refer to EDAM 1300.

12200 Qualified Taxpayer

References 17053.46(b)(5); 17053.46(c); 23646(b)(5); 23646(c)

A "qualified taxpayer" is any taxpayer engaged in a trade or business within a LAMBRA and, within the first two taxable years of commencing business within the LAMBRA, has a net increase in jobs (defined as 2,000 paid hours per employee per year) of one or more employees in the LAMBRA.

For qualified employees hired on or after January 1, 2001, the taxpayer shall obtain and retain certification (voucher) as discussed in EDAM 12430, that provides that a qualified employee meets the eligibility requirements applicable immediately preceding commencement with the taxpayer as discussed in EDAM 12400.

NOTE: Failure to obtain the certification (voucher) results in the taxpayer not meeting all the qualifications of a qualified taxpayer eligible for the hiring credit. A taxpayer must obtain a certification (voucher).

12210 Allowance of the LAMBRA Hiring Credit

References 17053.46(a); 17053.46(d)(4); 23646(a); 23646(d)(4)

Taxpayers engaged in operations within a LAMBRA are allowed to utilize the LAMBRA hiring credit beginning in the first year of operations within the LAMBRA even though they cannot fulfill the definition of a qualified taxpayer before the close of the second year of operations in the LAMBRA when the net increase in jobs is computed. If at the end of the second year the taxpayer does not meet the definition of a "qualified taxpayer", the LAMBRA hiring credit previously utilized needs to be recaptured.

12220 Pass-Through Entities

The determination of whether a taxpayer is a qualified taxpayer is made at the entity level. The term "pass-through entity" means any partnership or S corporation. The hiring credit is allowed to the pass-through entity and passed through to the partners or shareholders.

12230 Controlled Groups

References 17053.46(c)(1)(A); 17053.46(c)(1)(B); 23646(c)(1)(A); 23646(c)(2)

All employees of trades or businesses that are under common control, or members of the same controlled group of corporations, are treated as employed by a single taxpayer.

A controlled group of corporations is defined in IRC § 1563(a) as modified by the California Revenue & Taxation Code, to replace "at least 80%" with "more than 50%". The determination is made without regard to subsections (a)(4) and (e)(3)(C) of IRC § 1563.

NOTE: Controlled groups of taxpayers may not transfer employees between members to trigger or increase the credit.

12240 Acquired Businesses

References 17053.46(c)(2); 23646(c)(3)

For purposes of the hiring credit, if a major portion of a business is acquired from another employer, the employment relationship between the employee and the new employer is not treated as terminated if the employee continues employment in that business. Also, if a major portion of a separate unit of a business predecessor is acquired, the employment relationship between the employee and the new employer is not treated as terminated if the employee continues employment in that business.

NOTE: The new employer, "*steps into the shoes*" of the old employer for purposes of incurring future credits.

12300 Qualified Wages

References 17053.46(b)(1); 17053.46(b)(2); 17053.46(e); 23646(b)(1); 23646(b)(2)

EDAM 12310	Annual Wage Limitation
EDAM 12320	Estates and Trusts
EDAM 12330	Non-Qualified Wages
EDAM 12340	Minimum Wage Chart

Qualified wages are wages paid or incurred to employees (qualified) during the consecutive 60-month period beginning with the first day the employee commences employment with the taxpayer. For qualified employees hired before the expiration date of the LAMBRA, qualified wages paid or incurred within the 60-month period beginning with the first day the employee commences employment with the taxpayer shall continue to qualify for the credit after the area expiration date, as if the LAMBRA designation were still in existence and binding.

Qualified *wages* means that portion of hourly wages that does not exceed 150% of the minimum wage.

- Minimum wage means the wage established by the Industrial Welfare Commission. When the California minimum wage is higher than federal minimum wage, use the California minimum wage for purposes of this credit.
- To determine a salaried employee's hourly wage, divide the total salary by the average hours worked, normally 2,000 hours per year.

12310 Annual Wage Limitation

The total amount of qualified wages taken into account for purposes of claiming the credit shall not exceed two million dollars ($2,000,000) each taxable year.

12320 Estates and Trusts

In the case of an estate or trust, apportion the qualified wages between the estate/trust and the beneficiaries based on the income allocable to each. Consequently, any beneficiary, to whom wages are apportioned, is treated as the employer with respect to those wages.

12330 Non-Qualified Wages

Qualified wages *do not* include any wages paid or incurred on or after the area expiration date except as noted previously for qualified employees hired before the expiration of the LAMBRA.

12340 Minimum Wage Chart

Effective Date	**Minimum Wage**	**Maximum Wage (150% of Minimum Wage)**
Prior to October 1, 1996	$4.25	$6.37
October 1, 1996, through February 28, 1997	$4.75	$7.12
March 1, 1997 through August 31, 1997	$5.00	$7.50
September 1, 1997 through February 28, 1998	$5.15	$7.72
March 1, 1998 to December 31, 2000	$5.75	$8.62
January 1, 2001 to December 31, 2001	$6.25	$9.37
January 1, 2002 to Current	$6.75	$10.12

12400 Qualified Employee

References 17053.46(b)(4); 17053.46(b)(6); 23646(b)(4); 23646(b)(6)

EDAM 12410 Seasonal Employees
EDAM 12420 Leased Employees
EDAM 12430 Vouchering Form TCA EZ1

A *qualified employee* is either a "qualified disadvantaged individual" or a "qualified displaced employee".

A "qualified disadvantaged individual" is an individual who satisfies all of the following:

ANNUAL TESTS

- At least 90% of the individual's services for the taxpayer, during the taxable year, must be directly related to the conduct of the taxpayer's trade or business located within the LAMBRA;
- At least 50% of the individual's services for the taxpayer, during the taxable year, must be performed within the boundaries of the LAMBRA;

TIME OF HIRE TESTS

1. The individual is hired after the area was designated as a LAMBRA; and
2. Immediately prior to starting work for the taxpayer, the individual is any of the following:

For taxable years beginning on or after January 1, 1999:

1. Eligible for services under the federal Job Training Partnership Act (JTPA);
2. Eligible to be a voluntary or mandatory registrant under the Greater Avenues for Independence (GAIN) Act of 1985;
3. An economically disadvantaged individual 16 years of age or older;
4. A qualified dislocated worker (refer to the CR&TC or the 3807 Business Booklet for an expanded definition);
5. Enrolled in or has completed a state rehabilitation plan;
6. A service-connected disabled veteran;
7. A veteran of the Vietnam era;
8. A veteran who recently separated from military service;
9. An ex-offender;
10. A person who is a recipient of;
    - Federal Supplemental Security Income (SSI) benefits;
    - Aid to Families with Dependent Children (AFDC);

- Food stamps; or
- State and local general assistance;

11. A Native American.

For taxable years beginning on or after January 1, 1995, and before January 1, 1999:

3. Eligible for services under the federal Job Training Partnership Act (JTPA), or its successor;
4. Eligible to be a voluntary or mandatory registrant under the Greater Avenues for Independence (GAIN) Act of 1985, or its successor;
5. Eligible, as determined by EDD, under the federal Targeted Jobs Tax Credit Program, whether or not this program is in effect

A "qualified displaced employee" is an individual who satisfied all of the following:

ANNUAL TESTS

- At least 90% of the individual's work for the taxpayer, during the taxable year, must be directly related to the conduct of the taxpayer's trade or business located within the LAMBRA;
- At least 50% of the individual's services for the taxpayer, during the taxable year, must be performed within the boundaries of the LAMBRA;

TIME OF HIRE TESTS

- The individual is hired after the LAMBRA was designated as a LAMBRA; and
- The employee is a civilian or military employee of a base or former base who has been displaced as a result of a federal base closure act.

12410 Seasonal Employees

References 17053.46(b)(1)(C); 17053.46(b)(7); 23646(b)(1)(C); 23646(b)(7)

"Seasonal employment" means employment that has regular and predictable substantial reductions in business operations.

Reemployment of an individual, in connection with any increase (including a regularly occurring seasonal increase) in business operations, does not constitute commencement of employment for purposes of the LAMBRA hiring credit.

12420 Leased Employees

The "employer" is the qualified taxpayer and may qualify for the hiring credit for leased employees. The employer can be either the leasing company or the subscriber to the leasing company. Generally, the employer has the legal obligation to pay the payroll taxes of the employee, and the right to control and direct the workers (employee's) services.

Internal Revenue Service (IRS) Publication 15-A, *Employer's Supplemental Tax Guide* provides guidelines for establishing an employment relationship and provides examples to consider in determining the employer-employee relationship.

12430 Vouchering Form TCA EZ1

References 17053.46(c); 23646.7(c)

The *Form TCA EZ1* certifies that the employee meets the eligibility requirements of a qualified employee as discussed in EDAM 12400. The qualified taxpayer shall get *Form TCA EZ1* from one of the following applicable entities:

- The Employment Development Department (EDD);
- The local county JTPA administrative entity;
- The local city JTPA administrative entity;
- The local county GAIN office; or
- The local social services agency.

The EDD may provide preliminary screening and referral to the certifying agency. The qualified taxpayer needs to retain a copy of the certification and provide it upon request to the Franchise Tax Board.

NOTE: Failure to obtain the certification (voucher) results in the taxpayer not meeting all the qualifications of a qualified taxpayer eligible for the hiring credit. A taxpayer must obtain a certification (voucher).

12500 Credit Computation

References 17053.46(a); 17053.46(b)(1)(B); 17053.46(i); 23646(a); 23646(b)(1)(B); 23646(i)

For each taxable year beginning on or after January 1, 1995, a hiring credit is allowed to a qualified taxpayer for hiring a qualified employee for employment within a LAMBRA. The credit is equal to the sum of each of the following:

- 50% of the qualified wages during the first year of employment.
- 40% of the qualified wages during the second year of employment.
- 30% of the qualified wages during the third year of employment.
- 20% of the qualified wages during the fourth year of employment.
- 10% of the qualified wages during the fifth year of employment.

The total amount of qualified wages used to compute the LAMBRA hiring credit cannot exceed $2,000,000 per each taxable year.

The credit percentage is based on the employee's date of employment and subsequent anniversary dates. The taxpayer's tax year does not control the applicable credit percentages. With the exception of the first and last year of the credit, within one tax year, two percentage ranges for the computation of the credit is used.

Example: An employee was hired 7/1/1998, and the taxpayer is completing the tax return for the year ending 12/31/1999. For the period 1/1/1999 to 6/30/1999, the hiring credit is based on 50% of qualified wages. For the period 7/1/1999 to 12/31/1999, the hiring credit is based on 40% of qualified wages.

Once the employee commences employment, the credit percentage range begins and generally is not interrupted in the event of a subsequent layoff and rehire of the employee.

Example: An employee is hired 7/1/1998, is temporarily laid off 2/1/1999, and is rehired 4/1/1999. The 50% credit range runs from 7/1/1998 to 6/30/1999 regardless of the layoff period between 2/1/1999 and 3/31/1999.

In the case where an employee qualifies the taxpayer to take more than one wage credit, the taxpayer may claim only one credit for the same wage expense.

12510 Reduction for Other Tax Credits

References 17053.46(f); 23646(f)

The LAMBRA hiring credit is reduced by the credit allowed under CR&TC §17053.7 and 23621 (Jobs Tax Credit), and the federal credit allowed under IRC § 51 (Work Opportunity Tax Credit – WOTC).

12520 Wage Expense Reduction

References 17053.46(f); 23646(f)

The taxpayer must reduce any deduction for wages by the amount of the LAMBRA hiring credit allowed (includes any current year credit to be carried forward).

12530 Business Income Activity Limitation

References 17053.46(h); 23646(h)

The amount of the hiring credit or the sales or use tax credit (see Chapter 13) claimed, including any credit carryover from prior years, may not exceed the amount of tax on the taxpayer's LAMBRA business income in any year. Depending on the tax year involved, the LAMBRA business income is that portion of the taxpayer's *California source* business income or the worldwide income that is apportioned to the LAMBRA. Non-business income or loss is not included in the calculation of business income from the LAMBRA. Each taxpayer claiming the credit must compute the LAMBRA business income and resulting tax.

Example: Corp. A operates entirely within a LAMBRA. In order to determine the amount of hiring credit allowable, the business income and the tax on that business income must be determined. Corp. A has the following items of income and expense:

Income from business operations	$30,000
Interest from investment which is unrelated to Corp. A's business operations	$2,000
Business expenses	(17,000)
Net Taxable Income	$15,000

Corp. A's income attributed to business operations is:

Income from business operations	$30,000
Business expenses	(17,000)
Net Business Income	$13,000

To determine the LAMBRA hiring credit allowable, the net business income is multiplied by the current tax rate.

Net Business Income	$13,000
x 8.84%	x .0884
Tax associated with business income	$1,149

In this example, the taxpayer can offset the tax of $1,149 with the LAMBRA hiring credit available (up to $1,149).

NOTE: "tax"/"net tax" and alternative minimum tax impose limitations on the allowable offset but were not considered a factor in this example.

12540 General Provisions – Apportionment of Business Income

References 17053.46(h)(2); 17053.46(h)(3); 23646(h)(2); 23646(h)(3)

If a business is located within and outside of a LAMBRA, or in more than one LAMBRA, the taxpayer must determine the portion of the total business income that is attributable to the LAMBRA.

- Business income is defined under the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA).
- Components of the factors are defined under the provisions of UDITPA.

For taxable years beginning on or after January 1, 1998, business income shall be apportioned to the LAMBRA by multiplying the taxpayer's *California* source business income by a fraction, the numerator of which is the property factor plus the payroll factor, and the denominator of which is two (2).

For taxable years beginning on or after January 1, 1995, and before January 1, 1998, business income is apportioned to the LAMBRA by multiplying the *worldwide* business income by a fraction, the numerator of which is the property factor plus the payroll factor, and the denominator of which is two (2).

12541 Property Factor – Income Apportionment

The property factor is a fraction. The numerator of the property factor is the average value of the real and tangible personal property owned or rented and used or available for use by the taxpayer *within the LAMBRA* during the taxable year.

1. For taxable years beginning on or after January 1, 1998, the denominator is the average value of all real and tangible personal property owned or rented and used or available for use by the taxpayer during the taxable year *within California*.
2. For taxable years beginning on or after January 1, 1995, and before January 1, 1998, the denominator is the average value of all real and tangible personal property owned or rented and used or available for use during the taxable year *worldwide.*

Rented property is valued at 8 times the net annual rental rate. The net annual rental rate is the total rent paid for the property, less any subrental rates paid by subtenants.

12542 Payroll Factor – Income Apportionment

The payroll factor is a fraction. The numerator of the payroll factor is the total compensation paid to employees working for the taxpayer *within the LAMBRA* during the taxable year.

- For taxable years beginning on or after January 1, 1998, the denominator is the total compensation paid to employees working for the taxpayer *in California* during the taxable year.
- For taxable years beginning on or after January 1, 1995, and before January 1, 1998, the denominator is the total compensation paid to employees working *worldwide* during the taxable year.

Example: For the taxable year ending 12/31/99, Corp. A operates within and outside a LAMBRA. Total business income of $13,000 needs to be apportioned to the LAMBRA. The following amounts apply to Corp. A's property and payroll:

LAMBRA Property	$40,000
CA Property for Corp. A	$100,000
LAMBRA Payroll	$5,000
CA Payroll for Corp. A	$10,000

LAMBRA Property/CA Property	=.40	
LAMBRA Payroll/CA Payroll	=.50	
	.90/2 = .45	LAMBRA Apportionment Factor

Business income	$13,000
Apportionment Factor	x 0.45
LAMBRA Business Income	$5,850
Current Tax Rate	x .0884
Tax attributable to LAMBRA business income	$517

For an example of apportionment rules pre-1998, refer to EDAM 23440, *General Provisions - Income Apportionment*.

12543 Apportionment – Combined Groups

Taxable years beginning on or after 1/1/1998

For members of a combined group, the limitation is based on the intrastate apportioned business income for each taxpayer doing business within the LAMBRA. The numerator of the apportionment formula is based on each LAMBRA taxpayer's separate LAMBRA property and payroll factor amounts and the denominator is based on each LAMBRA taxpayer's separate California property and payroll factor amounts.

For taxable years beginning on or after January 1, 1995, and before January 1, 1998: For members of a combined group, the credit limitation is based on the combined groups worldwide business income (before CA apportionment). The numerator of the apportionment formula is based on each LAMBRA taxpayer's separate LAMBRA payroll and property amounts and the denominator is based on the combined groups worldwide payroll and property amounts.

For an example of apportionment under this method refer to EDAM 23440.

Example: For the taxable year ending 12/31/99, parent corporation A has two subsidiaries, B and C. Corporations A and B operate within a LAMBRA. The combined group operates within and outside California and apportions its income to California using Schedule R. The combined group's business income apportioned to California was $1,000,000. Corporation A and B's share of California business income is $228,000 and $250,000 respectively. Corporation A and B's separate LAMBRA and separate California property and payroll factor amounts are shown below.

Business income apportioned to the LAMBRA was determined as follows:

	A	B
Property Factor		
LAMBRA Property	$1,000,000	$ 800,000
California Property	$1,000,000	$1,200,000
Apportionment %	100%	66.66%
Payroll Factor		
LAMBRA Payroll	$800,000	$ 800,000
California Payroll	$800,000	$1,000,000
Apportionment %	100%	80%
Average Apport. % (Property + Payroll Factors)/2	100%	73.33%

Apportioned		
Business Income	$228,000	$250,000
LAMBRA Income	$228,000	$183,333

12544 Apportioning for Personal Income Tax Taxpayers

The following examples show the application of the apportioning rules to personal income tax taxpayers.

Example*:* Ray Smith is vice president of an S corporation that has two locations, one within a LAMBRA and one outside the LAMBRA. Eighty percent (80%) of the S corporation's business is attributable to the LAMBRA. (**NOTE**: This percentage was determined by the S corporation, using Worksheet IV from the FTB 3807 Business Booklet, at the time the S corporation return was prepared). Ray divides his time equally (50% & 50%) between the two offices of the S corporation.

Mary Smith (Ray's spouse) works for the S corporation at its office located within the LAMBRA.

Ray and Mary Smith have the following 1999 items of California income and expense:

Ray's salary from the S corp.	$100,000
Mary's salary from the S corp.	75,000
Interest on savings account	1,000
Dividends	3,000
Schedule K-1 (100S) from the S corp.	
Ordinary income	40,000
LAMBRA business expense deduction	(5,000)*
Ray's unreimbursed employee expenses from Schedule A	(2,000)

*The LAMBRA business expense deduction is a separately stated item on Schedule K-1 (100S).

The Smith's LAMBRA income is computed as follows:

Ray's LAMBRA salary ($100,000 x 50%)	$50,000
Mary's LAMBRA salary ($75,000 x 100%)	75,000
Pass-through ordinary income from the S-Corp. ($40,000 x 80%)	32,000
LAMBRA business expense deduction from the S-Corp.	(5,000)
Ray's unreimbursed employee business expenses (2,000 x 50%)	(1,000)
Total LAMBRA income	$151,000

Ray and Mary must compute the tax on the total LAMBRA income of $151,000 (as if it represents all of their income). Using the tax rate schedule for the filing status married filing joint; the 1999 tax on $151,000 is $10,659. The $10,659 is the first limitation on LAMBRA credits for the 1999 tax year. The second limitation on the credits is the net tax on all income.

NOTE: The standard deduction and personal or dependency exemptions are not included in the computation of LAMBRA income since they are not related to trade or business activities.

12545 S Corporations

References 17053.46(f); 23646(f); 23803(a)(1)(A); 23803(a)(1)(F)

An S corporation's hiring credit may reduce the LAMBRA tax at both the corporate and shareholder levels. However, the S corporation may only use one-third (1/3) of the credit to reduce the tax on the S corporation's LAMBRA income.

One hundred percent (100%) of the LAMBRA hiring credit is passed through to the S corporation shareholders. The full amount of the credit is reported on Schedule K (100S) and passed through to the shareholders on Schedules K-1 (100S).

The wage reduction for the S corporation is equivalent to the 1/3 credit amount. The wage reduction for the shareholders is 100% of the credit amount, equal to the amount of credit passing through to them.

Example: An S Corporation computes a $3,000 hiring credit. The S corporation's credit is $1,000 and the wage reduction is $1,000. The $3,000 credit is passed through to the S corporation's shareholders, and the wage reduction recognized by the shareholders is $3,000.

12600 Credit Usage & Carryover

References 17053.46(g); 17053.46(h)(1); 17053.46(h)(4); 23646(g); 23646(h)(1); 23646(h)(4)

EDAM 12610	Credit Will Not Reduce Certain Taxes
EDAM 12620	Credit Recapture
EDAM 12621	Non-Seasonal Employees
EDAM 12622	Seasonal Employees
EDAM 12623	Credit Recapture – Exceptions
EDAM 12624	Change in the Form of the Trade or Business
EDAM 12625	Special LAMBRA Recapture

The total amount of the LAMBRA hiring credit and sales or use tax credit, including any credit carryover from prior years, that may reduce the "tax"/"net tax" for the taxable year, shall not exceed the amount of tax imposed on the taxpayer's business income attributable to the LAMBRA, determined as if that income represented all of the income of the taxpayer.

The portion of the credit that exceeds the "tax"/"net tax" for the taxable year, is carried over and added to the credit, if any, in the following year. The credit is carried over to succeeding years, until it is exhausted.

Example: A taxpayer has a $4,900 LAMBRA hiring credit. Tax imposed on LAMBRA business income is $4,700, and the taxpayer's overall "net tax" is $4,000. The taxpayer would be eligible to claim a $4,000 maximum hiring credit.

Total LAMBRA hiring credit	$4,900
Tax on LAMBRA income	$4,700
First limitation:	
Lesser of total credit or tax on LAMBRA income	$4,700
Second limitation:	
Lesser of tax on LAMBRA income or "*net tax*"/"*tax*"	$4,000
Maximum credit allowed:	
Lesser of *LAMBRA tax limitation* or "*net tax*"/"*tax*" *limitation*	$4,000
Total LAMBRA hiring credit	$4,900
Maximum credit allowed	$4,000
Carryover	$ 900

In the event that a credit carryover is allowable for any taxable year after a LAMBRA designation has expired, the area is deemed to remain in existence for purposes of computing the business income limitation.

12610 Credit Will Not Reduce Certain Taxes

The LAMBRA hiring credit cannot reduce the:

- Minimum franchise tax (corporations, limited partnerships, limited liability partnerships, LLCs, and S corporations);
- Annual tax (partnerships, LLCs classified as partnerships, and Qsubs);
- Built-in gains tax (S corporations);
- Excess net passive income tax (S corporation);
- Alternative minimum tax (corporations, exempt organizations, individuals and fiduciaries); or
- Regular tax below tentative minimum tax.

12620 Credit Recapture

References 17053.46(d)(1)(A); 17053.46(d)(1)(B); 17053.46(d)(3); 23646(d)(1)(A); 23646 (d)(1)(B); 23646 (d)(3)

12621 Non-Seasonal Employees

Recapture of the hiring credit is required if the employee is terminated before the end of the longer of the following two periods:

- The first 270 "days of employment" (whether or not consecutive); or
- Ninety (90) "days of employment" plus 270 calendar days.

To recapture the credit, the taxpayer must add to the current year's tax the amount of credit claimed for the year of termination, as well as all prior year credit claimed for the terminated employee.

12622 Seasonal Employees

For taxable years beginning on or after January 1, 1998, for seasonal employees, the taxpayer must recapture the amount of the credit if employment is terminated before the completion of 270 "days of employment" during the 60-month period beginning the day the employee commences employment with the taxpayer except as subsequently discussed.

To recapture the credit, the taxpayer must add the amount of credit previously claimed in all years to the tax for the tax year that includes the 60^{th} month of employment.

For all employees, a ‘‘day of employment’’ includes any day the employee was paid to work, regardless of whether the employee actually worked (including paid holidays, sick days, and vacation days).

NOTE: Any increase in tax, due to credit recapture, cannot be offset by the current year hiring credit.

12623 Credit Recapture – Exceptions

References 17053.46(d)(2)(A); 17053.46(d)(2)(B); 23646(d)(2)(A); 23646(d)(2)(B)

For both regular and seasonal employees, the credit recapture will not apply if the termination was:

- Voluntary on the part of the employee;
- Caused by the employee becoming disabled;
- Due to employee misconduct;
- Due to a substantial reduction in business; or
- In order to enable other qualified employees to be hired, creating an increase in the number of qualified employees and the hours of employment.

12624 Change in the Form of the Trade or Business

References 17053.74(e)(2)(C); 23622.7(e)(2)(C)

The employment relationship between the taxpayer and an employee is not treated as terminated by reason of a mere change in the form of conducting the trade or business. If the employee continues employment in that trade or business and the taxpayer retains a substantial interest in that trade or business, the employee is not treated as terminated.

12625 Special LAMBRA Recapture

References 17053.45(b)(2); 17053.45(g)(2); 23645(b)(2); 23645(g)(2)

The taxpayer must have a *net increase of one or more jobs in the LAMBRA* at the close of the second taxable year of doing business within a LAMBRA. If there is not a net increase of one or more jobs, the credit previously claimed is added to the taxpayer's "net tax"/"tax" for the second taxable year.

The net increase in the number of jobs is determined by applying two tests:

The first test requires a taxpayer to subtract the number of full-time employees (defined as 2,000 paid hours per employee per year) employed in this state in the taxable year prior to commencing business operations in the LAMBRA from the total number of full-time employees employed in this state during the second taxable year after commencing business operations in the LAMBRA.

- For taxpayers that commence doing business in this state with their LAMBRA business operation, the number of employees for the taxable year prior to commencing business operations in the LAMBRA shall be zero.

If the first test is met, the credit is allowed only if the second test is met which is one or more full-time employees are employed within the LAMBRA.

To determine the first test of the net increase in jobs requirement, the following formula is used:

- The total number of hours worked in this state, by the taxpayer's CA employees (not to exceed 2,000 hours per employee) who are paid an hourly wage, divided by 2,000, plus
- The total number of months worked in this state, by the taxpayer's CA employees who are salaried employees, divided by 12.

NOTE: For taxpayers that first commence doing business in the LAMBRA during the taxable year, the divisors “2,000” and “12” shall be multiplied by a fraction, the numerator of which is the number of months of the taxable year that the taxpayer was doing business in the LAMBRA and the denominator of which is 12.

To determine the second test of the net increase in jobs requirement, the following formula is used:

- The total number of hours worked in this state, by the taxpayer's LAMBRA employees (not to exceed 2,000 hours per employee) who are paid an hourly wage, divided by 2,000, plus,
- The total number of months worked in this state, by the taxpayer's LAMBRA employees who are salaried employees, divided by 12.

Example: A Corporation employs four individuals before establishing operations in the LAMBRA on January 1, 1998. The following is the employment information for the employees for the taxable year prior to operating in the LAMBRA:

- Employee #1: Salaried, employed for 12 months.
- Employee #2: Hourly, full-time; worked 2,080 hours per year.
- Employee #3: Hourly, part-time; worked 1,500 hours per year.
- Employee #4: Hourly, part-time; worked 1,500 hours per year.

The corporation moves its entire operations within the LAMBRA on January 1, 1998. At the end of the first year of operation within the LAMBRA, the corporation employed the following individuals:

- Employee #1: Salaried; employed 24 months.
- Employee #2: Hourly, full-time; worked 2,080 hours during the year.
- Employee #3: Hourly, part-time; worked 2,000 hours during the year.
- Employee #4: Hourly, part-time; worked 1,600 hours during the year.
- Employee #5: Hourly, part-time; worked 1,600 hours during the year.

At the end of the 2nd year of operation in the LAMBRA, the corporation employed the following individuals:

- Employee #1: Salaried; employed 36 months.
- Employee #2: Hourly, full-time; worked 2,080 hours during the year.
- Employee #3: Hourly, part-time; worked 2,000 hours during the year.
- Employee #4: Hourly, part-time; worked 1,700 hours during the year.
- Employee #5: Hourly, part-time; worked 1,900 hours during the year.

The first test for the net increase in jobs is computed as follows:

<u>For the taxable year beginning prior to 1/1/98, (the relocation date to the LAMBRA):</u>

<u>Hourly Employees</u>:

Employee #2	2000 hours
Employee #3	1500 hours

Employee #4	1500 hours
Total	5000 hours
Divide by 2000	
Total hourly employees	2.5 employees

Salaried Employees	
Employee #1	12 months
Total	12 months
Divide by 12	
Total Salaried employees	1.0 employee
Total employees	3.5 employees

At the end of the 2nd year of operation in the LAMBRA:

Hourly Employees:	
Employee #2	2000 hours
Employee #3	2000 hours
Employee #4	1700 hours
Employee #5	1900 hours
Total	7600 hours
Divide by 2000	
Total hourly employees	3.8 employees

Salaried Employees	
Employee #1	12 months
Total	12 months
Divide by 12	
Total Salaried employees	1.0 employee
Total employees	4.8 employees

Subtract the total employees employed in the year before beginning operations in the LAMBRA from the employees employed at the end of the second year of operations in the LAMBRA

Employees employed at the end of the second Year of operation in the LAMBRA	4.8 employees
Employees employed prior to relocation To the LAMBRA	3.5 employees
Total increase	1.3 employees

The taxpayer has met the first test of the net increase in jobs requirement. The taxpayer had a net increase of at least one employee in the state of CA at the close of the two-year period that began when the taxpayer relocated into the LAMBRA.

- If the taxpayer did not have a net increase of one or more employees during this time-period, all LAMBRA tax incentives must be recaptured.

The second test for the net increase in jobs is computed as follows:

At the end of the 1st year of operation in the LAMBRA:

Hourly Employees:	
Employee #2	2000 hours
Employee #3	2000 hours
Employee #4	1600 hours
Employee #5	1600 hours
Total	7200 hours
Divide by 2000	
Total hourly employees	3.6 employees
Salaried Employees	
Employee #1	12 months
Total	12 months
Divide by 12	
Total Salaried employees	1.0 employee
Total employees at the end of the 1st year of operation in the LAMBRA	4.6 employees

At the end of the 2nd year of operation in the LAMBRA:

Hourly Employees:	
Employee #2	2000 hours
Employee #3	2000 hours
Employee #4	1700 hours
Employee #5	1900 hours
Total	7600 hours
Divide by 2000	
Total hourly employees	3.8 employees
Salaried Employees	
Employee #1	12 months

Total	12 months
Divide by 12	
Total Salaried employees	1.0 employee
Total employees at the end of the 2nd year of operation in the LAMBRA	4.8 employees

The taxpayer has met the second test of the net increase in jobs requirement. The taxpayer had at least one employee in the LAMBRA in each of the first two years of operations in the LAMBRA.

- If the taxpayer did not have at least one employee in the LAMBRA during these time periods, all LAMBRA tax incentives must be recaptured.

12700 Record Keeping Requirements

For each qualified employee, documentation should be kept to show the following:

- Certification Voucher – form TCA EZ1 (employees hired on or after January 1, 2001).
- Employee name
- Date employee was hired
- Number of hours the employee worked for each month of employment
- Wage rate paid for each month of employment
- Schedule calculating the hiring credit
- Overtime hours
- Location where services were performed
- Date employee was terminated, and reason why

Section 13000 LOCAL AGENCY MILITARY BASE RECOVERY AREA (LAMBRA) SALES OR USE TAX CREDIT

References 17053.45(a); 17053.45(b)(3)(B); 23645(a); 23645(b)(3)(B)

For each taxable year beginning on or after January 1, 1995, a taxpayer engaged in a trade or business within a designated Local Agency Military Base Recovery Area (LAMBRA) can take a credit for sales or use tax paid or incurred in connection with the purchase of qualified property.

- In any year, individuals may claim a credit equal to the sales or use tax paid or incurred on the purchase of the first $1 million of qualified property.
- In any year, corporations may claim a credit equal to the sales or use tax paid or incurred on the purchase of the first $20 million of qualified property. (See special rule for S corporations and shareholders in EDAM 13600.)

No credit may be claimed for property purchased after the LAMBRA designation expires, is no longer binding, or becomes inoperative.

13100 Geographic Boundaries and Designation Dates

For a listing of LAMBRAs, refer to EDAM 1320. To verify an address, refer to EDAM 1300.

13200 Exclusive Credit

References 17053.45(h); 23645(h)

If the LAMBRA sales or use tax credit is claimed for the purchase of qualified property during the taxable year, no other credit is allowed with respect to that property.

13300 "Taxpayer" Defined

References 17053.45(b)(2); 23645(b)(2)

EDAM 13310	Allowance of the LAMBRA Sales or Use Tax Credit
EDAM 13320	Pass-Through Entities

A "taxpayer" is a person or entity engaged in a trade or business within a LAMBRA and, for the first two taxable years, has a net increase in jobs (defined as 2,000 paid hours per employee per year) of one or more employees in the LAMBRA.

13310 Allowance of the LAMBRA Sales or Use Tax Credit

Taxpayers engaged in operations within a LAMBRA are allowed to utilize the LAMBRA credit beginning in the first year of operations within the LAMBRA even though they cannot fulfill the definition of a qualified taxpayer before the close of the second year of operations in the LAMBRA when the net increase in jobs is computed. If at the end of the second year the taxpayer does not meet the definition of a “qualified taxpayer”, the LAMBRA credit previously utilized must be recaptured.

13320 Pass-Through Entities

The determination of whether a taxpayer is a qualified taxpayer is made at the entity level. The term "pass-through entity" means any partnership or S corporation. The sales or use tax credit is allowed to the pass-through entity and passed through to the partners or shareholders.

13400 Qualified Property

References 17053.45(b)(3); 23645(b)(3)

Qualified property is property purchased by the taxpayer for exclusive use in the LAMBRA and includes, but is not limited to, the following:

- High technology equipment, such as computers and electronic processing equipment;
- Aircraft maintenance equipment, such as engine stands, hydraulic mules, power carts, test equipment, hand tools, aircraft start carts, and tugs;
- Aircraft components, such as engines, fuel control units, hydraulic pumps, avionics, starts, wheels, and tires; and
- Section 1245 property, as defined in Section 1245(a)(3) of the Internal Revenue Code.

13410 Capitalized Requirement

References 17053.45(b)(3); 17053.45(e); 23645(b)(3); 23645(e)

Qualified property must be purchased and placed in service before the LAMBRA expires, is no longer binding or becomes inoperative. Qualified property cost(s) are costs chargeable to a capital account (subject to depreciation) of the qualified taxpayer. If costs are expensed, rather than capitalized, no credit is allowed.

13420 Leased Property

Taxpayers who acquire property by lease arrangement may qualify for the sales or use tax credit. Lease arrangements structured using a financial (conditional sales) contract generally will qualify the taxpayer to take the sales or use tax credit. For reference sources to determine if a lease qualifies as a purchase rather than a lease arrangement, refer to IRS Revenue Ruling 55-540, 1955-2 C.B. 39, and FTB Legal Ruling 94-2, March 23, 1994.

13500 Credit Computation – Asset Value Limitation

References 17053.45(a); 23645(a)

EDAM 13510	Use Tax Paid on Qualified Property
EDAM 13520	Depreciable Basis
EDAM 13530	Business Income Activity Limitation
EDAM 13540	General Provisions – Apportionment of Business Income
EDAM 13541	Property Factor – Income Apportionment
EDAM 13542	Payroll Factor – Income Apportionment
EDAM 13543	Apportionment – Combined Groups
EDAM 13544	Apportioning for Personal Income Tax Taxpayers

The sales or use tax credit is equal to the amount of sales or use tax “paid or incurred” by the taxpayer in connection with the purchase and use of qualified property.

Example: Taxpayer spent $53,750 to purchase property used in the taxpayer's business within the LAMBRA. The sales tax paid on the purchase is $3,750. The sales tax credit is $3,750.

Individuals, estates or trusts, partnerships, and limited liability companies (LLCs) taxed as partnerships may claim a credit on the sales or use tax paid or incurred to purchase up to $1 million of qualified property. Corporations may claim a credit on the sales or use tax paid or incurred to purchase up to $20 million of qualified property. This limitation applies to each taxable year. (See special rule for S corporations and shareholders in EDAM 13600.)

NOTE: Upon acquisition, if the taxpayer/purchaser was exempt from paying sales tax on the property under the California Revenue & Taxation Code (CR&TC), then the taxpayer/purchaser did not pay or incur sales tax in connection with the purchase of the property to the extent of the exemption. Thus, the taxpayer/purchaser is not allowed to take the sales or use tax credit for the exemption amount.

13510 Use Tax Paid on Qualified Property

References 17053.45(c); 23645(c)

If a taxpayer, operating within a LAMBRA, purchases property out of state and pays or incurs a use tax, the credit is allowed only if qualified property of a comparable quality and price is not timely available for purchase in this state.

13520 Depreciable Basis

References 17053.45(e); 23645(e)

Any taxpayer that elects to claim the sales or use tax credit, shall *not* increase the basis of the qualified property by the amount of the sales or use tax paid or incurred.

Example: Taxpayer spent $53,750 to purchase property used in the taxpayer's business within the LAMBRA. The sales tax included in the purchase price was $3,750. The basis of the property is $50,000 ($53,750 less $3,750 sales tax).

13530 Business Income Activity Limitation

References 17053.45(f)(1); 23645(f)(1)

See EDAM 12530.

13540 General Provisions – Apportionment of Business Income

References 17053.45(f)(1); 17053.45(f)(2)(A); 23645(f)(1); 23645(f)(2)(A)

If a business is located within and outside of a LAMBRA, or in more than one LAMBRA, the taxpayer must determine the portion of the total business income that is attributable to the LAMBRA.

- Business income is defined under the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA).
- Components of the factors are defined under the provisions of UDITPA.

For taxable years beginning on or after January 1, 1998, business income shall be apportioned to the LAMBRA by multiplying the taxpayer's *California* source business income by a fraction, the numerator of which is the property factor plus the payroll factor, and the denominator of which is two (2).

For taxable years beginning on or after January 1, 1995, and before January 1, 1998, business income is apportioned to the LAMBRA by multiplying the *worldwide* business income by a fraction, the numerator of which is the property factor plus the payroll factor, and the denominator of which is two (2).

13541 Property Factor – Income Apportionment

The property factor is a fraction. The numerator of the property factor is the average value of the real and tangible personal property owned or rented and used or available for use by the taxpayer *within the LAMBRA* during the taxable year.

- For taxable years beginning on or after January 1, 1998, the denominator is the average value of all real and tangible personal property owned or rented and used or available for use by the taxpayer during the taxable year *within California.*
- For taxable years beginning on or after January 1, 1995, and before January 1, 1998, the denominator is the average value of all real and tangible personal property owned or rented and used or available for use during the taxable year *worldwide.*

Rented property is valued at 8 times the net annual rental rate. The net annual rental rate is the total rent paid for the property, less any subrental rates paid by subtenants.

13542 Payroll Factor – Income Apportionment

The payroll factor is a fraction. The numerator of the payroll factor is the total compensation paid to employees working for the taxpayer *within the LAMBRA* during the taxable year.

- For taxable years beginning on or after January 1, 1998, the denominator is the total compensation paid to employees working for the taxpayer *in California* during the taxable year.
- For taxable years beginning on or after January 1, 1995, and before January 1, 1998, the denominator is the total compensation paid to employees working *worldwide* during the taxable year.

Example: For taxable year ending 12/31/1998, Corp. A operates within and outside a LAMBRA. Total business income of $13,000 needs to be apportioned to the LAMBRA. The following amounts apply to Corp. A's property and payroll:

LAMBRA Property	$40,000
CA Property for Corp. A	$100,000
LAMBRA Payroll	$5,000
CA Payroll for Corp. A	$10,000

LAMBRA Property/CA Property	=.40	
LAMBRA Payroll/CA Payroll	=.50	
	.90/2 = .45	LAMBRA Apportionment Factor

Business income	$13,000
Apportionment Factor	x 0.45
LAMBRA Business Income	$5,850
Current Tax Rate	x .0884
Tax attributable to LAMBRA business income	$517

For an example of apportionment rules pre-1998, refer to EDAM 23440, *General Provisions - Income Apportionment*.

13543 Apportionment – Combined Groups

For taxable years beginning on or after 1/1/1998: For members of a combined group, the limitation is based on the intrastate apportioned business income for each taxpayer doing business within the LAMBRA. The numerator of the apportionment formula is based on each LAMBRA taxpayer's separate LAMBRA property and payroll amounts and the denominator is based on each LAMBRA taxpayer's separate California property and payroll amounts.

For taxable years beginning on or after January 1, 1995, and before January 1, 1998: For members of a combined group, the credit limitation will be based on the combined groups worldwide business income (before CA apportionment). The numerator of the apportionment formula is based on each LAMBRA taxpayer's separate LAMBRA payroll and property amounts and the denominator is based on the combined groups worldwide payroll and property amounts.

For an example of apportionment under this method refer to EDAM 23000.

Example: For taxable year ended 12/31/2001, parent corporation A has two subsidiaries, B and C. Corporations A and B operate within a LAMBRA. The combined group operates within and outside California and apportions its income to California using Schedule R. The combined group's business income apportioned to California was $1,000,000. Corporation A and B's share of California business income is $228,000 and $250,000 respectively. Corporation A and B's separate LAMBRA and separate California property and payroll factor amounts are shown below.

Business income apportioned to the LAMBRA was determined as follows:

	A	B
Property Factor		
LAMBRA Property	$1,000,000	$ 800,000
California Property	$1,000,000	$1,200,000
Apportionment %	100%	66.66%
Payroll Factor		
LAMBRA Payroll	$800,000	$ 800,000
California Payroll	$800,000	$1,000,000
Apportionment %	100%	80%
Average Apport. %	100%	73.33%
(Property + Payroll Factors)/2		

Apportioned Business Income	$228,000	$250,000
LAMBRA Income	$228,000	$183,333

13544 Apportioning for Personal Income Tax Taxpayers

The following examples show the application of the apportioning rules to personal income tax taxpayers.

Example*:* Ray Smith is vice president of an S corporation that has two locations, one within a LAMBRA and one outside the LAMBRA. Eighty percent (80%) of the S corporation's business is attributable to the LAMBRA. (**NOTE**: This percentage was determined by the S corporation, using Worksheet IV from the FTB 3807 Business Booklet, at the time the S corporation return was prepared). Ray divides his time equally (50% & 50%) between the two offices of the S corporation.

Mary Smith (Ray's spouse) works for the S corporation at its office located within the LAMBRA.

Ray and Mary Smith have the following 1999 items of California income and expense:

Ray's salary from the S corp.	$100,000
Mary's salary from the S corp.	75,000
Interest on savings account	1,000
Dividends	3,000
Schedule K-1 (100S) from the S corp.	
Ordinary income	40,000
LAMBRA business expense deduction	(5,000)*
Ray's unreimbursed employee expenses from Schedule A	(2,000)

*The LAMBRA business expense deduction is a separately stated item on Schedule K-1 (100S).

The Smith's LAMBRA income is computed as follows:

Ray's LAMBRA salary ($100,000 x 50%)	$50,000
Mary's LAMBRA salary ($75,000 x 100%)	75,000
Pass-through ordinary income from the S-Corp. ($40,000 x 80%)	32,000
LAMBRA business expense deduction from the S-Corp.	(5,000)
Ray's unreimbursed employee business expenses (2,000 x 50%)	(1,000)
Total LAMBRA income	$151,000

Ray and Mary must compute the tax on the total LAMBRA income of $151,000 (as if it represents all of their income). Using the tax rate schedule for the filing status married filing joint; the 1999 tax on $151,000 is $10,659. The $10,659 is the first limitation on LAMBRA credits for the 1999 tax year. The second limitation on the credits is the net tax on all income.

NOTE: The standard deduction and personal or dependency exemptions are not included in the computation of LAMBRA income since they are not related to trade or business activities.

13600 S Corporation & Shareholder Credit Amounts

References 17053.45(a); 23645(a); 23803(a)

S corporations operating within a LAMBRA may claim a credit on the sales or use tax paid or incurred to purchase up to $20 million of qualified property. This limitation applies to each taxable year. The S corporation may only use one-third (1/3) of the credit to reduce the tax on the S corporation's LAMBRA business income.

An S corporation's sales or use tax credit may reduce the LAMBRA tax at both the corporate and shareholder levels. One hundred percent (100%) of the LAMBRA credits are passed through to the S corporation shareholders. However, S corporation shareholders are only allowed to claim a credit on the sales or use tax paid or incurred on the purchase of up to $1 million of qualified property of the S corporation for each taxable year. The shareholders claim their pro-rata share of this credit as recomputed under the California personal income tax law (Part 10).

The sales or use tax credit is first computed for the S corporation using the actual qualified acquisition costs not to exceed $20 million. The amount of credit passing through to the shareholders is then computed using the actual qualified acquisition costs not to exceed $1 million. This credit based on the $1 million limitation is passed through to the shareholders based on their pro rata share. The Schedules K (100S) and K-1 (100S) must state the credit amounts allocable to the shareholders.

Example: Corp. Z, an S corporation, purchases $2 million of qualified property, and elects to take the LAMBRA sales or use tax credit. Corp. Z is allowed to claim a sales or use tax credit of $50,000 ($2,000,000 x 7.5% x 1/3 = $50,000). [Cost (not to exceed $20,000,000) x sales tax rate x 1/3 S corporation credit limitation]

The corporation's two shareholders allocate between them a sales or use tax credit of $75,000 ($1,000,000 x 7.5% = $75,000). [Cost (not to exceed $1,000,000) x sales tax rate]

NOTE: The State Board of Equalization, in an unpublished (non-citable) decision, concluded that the $20 million limitation applied to the S-Corp and the $1 million limitation applied collectively to the S-Corp shareholders. *Appeal of Barry and Wendy Breslow, Cal. St. Bd. Of Equal., November 6, 2001.*

13700 Sales or Use Tax Credit and the Hiring Credit

References 17053.45(f)(1); 23645(f)(1)

The amount of credit(s) allowed, in any taxable year, when a taxpayer is eligible to take both the sales or use tax credit and the hiring credit, is limited to the amount of tax imposed on the LAMBRA business income. Thus, the taxpayer must aggregate the credits and limit the total amount of credits to tax imposed on the LAMBRA business income.

13800 Credit Usage and Carryover

References 17053.45(d); 17053.45(f)(1); 23645(d); 23645(f)(1)

EDAM 13810	Credit Will Not Reduce Certain Taxes
EDAM 13820	Depreciation
EDAM 13830	Credit Recapture
EDAM 13831	Special LAMBRA Recapture

The portion of the credit that exceeds the "net tax"/"tax" for the taxable year, may be carried over and added to the credit, if any, in the following year. The credit is carried over to succeeding years, until it is exhausted.

The aggregate amount of the LAMBRA credit, including any credit carryover from prior years, that may reduce the "net tax"/"tax" for the taxable year, shall not exceed the amount of tax imposed on the taxpayer's business income attributable to the LAMBRA, determined as if that income represented all of the income of the taxpayer.

Example: A taxpayer has $4,900 in LAMBRA credits (sales or use tax credit and hiring credit). Tax imposed on LAMBRA business income is $4,700 and the taxpayer's overall "net tax"/"tax" is $4,000. The maximum amount of credit is limited to the lesser of the tax on the LAMBRA business income, or the tax on the taxpayer's overall "net tax"/"tax".

Total LAMBRA credit	$4,900
Tax on LAMBRA income	$4,700
First limitation:	
Lesser of total credit or tax on LAMBRA income	$4,700
Second limitation:	
Lesser of tax on LAMBRA income or "*net tax*"/"*tax*"	$4,000
Maximum credit allowed:	
Lesser of *LAMBRA tax limitation* or "*net tax*"/"*tax*" *limitation*	$4,000
Total LAMBRA credit	$4,900
Maximum credit allowed	$4,000
Carryover	$ 900

In the event that a credit carryover is allowable for any taxable year after the LAMBRA designation has expired; the LAMBRA is deemed to remain in existence for the purpose of computing the business income limitation.

13810 Credit Will Not Reduce Certain Taxes

The LAMBRA sales or use tax credit cannot reduce the:

- Minimum franchise tax (corporations, limited partnerships, limited liability partnerships, LLCs, and S corporations);
- Annual tax (partnerships, LLCs classified as partnerships and Qsubs);
- Built-in gains tax (S corporations);
- Excess net passive income tax (S corporation);
- Alternative minimum tax (corporations, exempt organizations, individuals and fiduciaries); or
- Regular tax below tentative minimum tax.

13820 Depreciation

References 17053.45(e); 18036; 23645(e); 24916

Taxpayers electing to utilize the sales or use tax credit are not entitled to increase the basis of the property for which sales or use tax was paid or incurred in connection with the purchase of the property.

Depreciation of the capitalized cost of the asset may be claimed using any method of depreciation allowable beginning in the year the asset is placed in service.

NOTE: If the business expense deduction is taken for the same property, depreciation will start with the taxable year following the year in which the property is placed in service. The depreciation is calculated on the remaining basis *after* reduction for the sales or use tax credit and business expense deduction amounts.

13830 Credit Recapture

References 17053.45(g)(1); 23645(g)(1): See also Cal. Code Regs. (CCR) § 17267.2-1(a); 24356.7-1

Recapture of the LAMBRA sales or use tax credit is required if the qualified property is disposed of or no longer used by the taxpayer in the LAMBRA at any time before the close of the second taxable year after the property is placed in service. The amount of the credit previously claimed for that property is added to the taxpayer's tax liability in the taxable year of that disposition or nonuse.

Example: Corp. A purchases property on June 11, 1998 that qualifies Corp. A to take the LAMBRA sales or use tax credit. Corp. A's taxable year ends December 31 of each year. Corp. A disposes of the property August 5, 2000. The credit is recaptured in the 2000 tax year as the property was disposed of before the close of the second taxable year [12/31/2000] after the property was placed in service.

NOTE: The State Board of Equalization in an unpublished and (uncitable) decision agreed that the statute requires the closure of two taxable years after the end of the taxable year in which the property is placed in service and the election to claim the deduction on the original return is made. *Appeal of Accurate Metal Fabricators, Inc. 32552, Cal. St. Bd. Of Equal., July 3, 2000.*

13831 Special LAMBRA Recapture

References 17053.45(b)(2); 17053.45(g)(2); 23645(b)(2); 23645(g)(2)

See EDAM 12625.

13900 Record Keeping Requirements

To support the sales or use tax credit claimed, the taxpayer must keep all records that document the purchase of the qualified property. This includes items such as purchase receipts and proof of payment. In addition, taxpayers should keep all records that identify or describe:

- The property purchased (such as serial numbers, etc.);
- The amount of sales or use tax paid or incurred upon purchase;
- The location where the property is used; and
- If purchased from a manufacturer located outside California, records to substantiate that property of comparable quality and price was not available for purchase in California.

Section 14000 LOCAL AGENCY MILITARY BASE RECOVERY AREA BUSINESS EXPENSE DEDUCTION

References 17268(a); 17268(d)(4); 17268(e)(1); 24356.8(a); 24356.8(d)(1)

For each taxable year beginning on or after January 1, 1995, a person or entity (other than an estate or trust) engaged in a trade or business within a Local Agency Military Base Recovery Area (LAMBRA) may elect to treat 40% of the eligible cost of qualified property as a business expense rather than a capital expense.

The deduction is allowed for the taxable year in which the property is placed in service.

14100 Geographic Boundaries and Designation Dates

For a listing of LAMBRAs, refer to EDAM 1320. To verify an address, refer to EDAM 1300.

14200 "Taxpayer" Defined

References 17268(e)(2); 24356.8(d)(2)

EDAM 14210	Allowance of the LAMBRA Business Expense Deduction
EDAM 14220	Estates and Trusts
EDAM 14230	Pass-Through Entities

A "taxpayer" is a person or entity engaged in a trade or business within a LAMBRA and, for the first two taxable years, has a net increase in jobs (defined as 2,000 paid hours per employee per year) of one or more employees in the LAMBRA.

14210 Allowance of the LAMBRA Business Expense Deduction

Taxpayers engaged in operations within a LAMBRA are allowed to utilize the LAMBRA business expense deduction beginning in the first year of operations within the LAMBRA even though they cannot fulfill the definition of a qualified taxpayer before the close of the second year of operations in the LAMBRA when the net increase in jobs is computed. If at the end of the second year the taxpayer does not meet the definition of a "qualified taxpayer", the LAMBRA business expense deduction previously utilized must be recaptured.

14220 Estates and Trusts

References 17268(d)(4)

Estates and trusts are not allowed to take the business expense deduction.

14230 Pass-Through Entities

The determination of whether a taxpayer is a qualified taxpayer is made at the entity level. The term "pass-through entity" means any partnership or S corporation. The business expense deduction is allowed to the pass-through entity and passed through to the partners or shareholders.

14300 Qualified Property

References 17268(d); 17268(g); 24356.8(c); 24356.8(g)

EDAM 14310 Leased Property
EDAM 14320 Property Not Qualified

Qualified property is IRC § 1245 property (as defined in Section 1245(a)(3) of the Internal Revenue Code) purchased and placed in service for exclusive use in a trade or business conducted within a LAMBRA. The property must also be purchased and placed in service before the date the LAMBRA designation expires, is no longer binding, or becomes inoperative.

Qualified property under IRC § 1245 includes, but is not limited to, tangible personal property (excluding buildings and inventory) that is subject to the allowance for depreciation. This includes most equipment and furnishings purchased for *exclusive use* within a LAMBRA. Office supplies and other small non-depreciable items are not included.

14310 Leased Property

Taxpayers who acquire property by lease arrangement may be able to take the business expense deduction. The structure of the leasing arrangement itself is critical. Lease arrangements structured using a financial (conditional sales) contract generally will qualify the taxpayer to take the business expense deduction. For reference sources to determine if a lease qualifies as a purchase rather than a lease arrangement, refer to IRS Revenue Ruling 55-540, 1955-2 C.B. 39, and FTB Legal Ruling 94-2, March 23, 1994.

14320 Property Not Qualified

References 17268(d); 24356.8(c)

The business expense deduction is not allowed if the property:

- Was transferred between members of an affiliated group;
- Was acquired as a gift or inherited;
- Was traded for other property;
- Is property for which the taxpayer may not make an election under IRC § 179 due to the provisions of IRC § 179(d);
- Was received from a personal or business relation as defined by IRC § 267, as modified by CR&TC § 17268(d)(2)(A) and 24356.8(c)(2)(A) for a LAMBRA;
- Was received from a personal or business relation as defined by IRC § 707(b); or
- Is described in IRC § 168(f).

14400 Deduction Amount

References 17268(f); 24356.8(f)

EDAM 14410 Pass-Through Entities
EDAM 14420 Personal Income Tax Taxpayers-Married Filing Separate
EDAM 14430 Basis reduction / Depreciation
EDAM 14440 Interaction with the Manufacturer's Investment Credit

For taxable years beginning on or after January 1, 1999, the *maximum* deduction the taxpayer may claim in any taxable year is determined by the number of years that have elapsed since the area was designated, as follows:

Taxable Years	Maximum Aggregate Cost	Maximum Deduction
Taxable year of designation and 1st year thereafter	$100,000	$40,000
2nd and 3rd taxable year thereafter	$75,000	$30,000
Each taxable year thereafter	$50,000	$20,000

For taxable years beginning before January 1, 1999, the maximum *deduction* the taxpayer may claim in any taxable year is determined by the number of years that have elapsed since the area was designated, as follows:

Taxable Years	Maximum Deduction
Taxable year of designation and 1st year thereafter	$5,000
2nd and 3rd taxable year thereafter	$ 7,500
Each taxable year thereafter	$10,000

14410 Pass-Through Entities

References 17268(d)(6); 24356.8(c)(8)

In the case of pass-through entities, the percentage limitation (40%), of the aggregate cost of all qualified property, shall apply at the entity level and at the partner/shareholder level.

14420 Personal Income Tax Taxpayers-Married Filing Separate

References 17268(b)

In the case of a husband and wife filing separate returns for a taxable year, the applicable deduction is equal to one-half (50%) of the otherwise allowable deduction.

14430 Basis reduction / Depreciation

The basis (cost for depreciation purposes) of the property is reduced by the amount allowed as a deduction. Depreciation of the cost of the property, less the amount deducted, may be claimed using any method of depreciation normally allowed. **NOTE:** Depreciation will start with the taxable year following the year in which the property is placed in service. The depreciation is calculated on the remaining basis *after* reduction for the business expense deduction.

Taxpayers electing to take the business expense deduction cannot claim the additional first year depreciation (IRC § 179 or CR&TC § 24356) for the same property.

14440 Interaction with the Manufacturer's Investment Credit

References 17053.49(b)(1)(C); 23649(b)(1)(C)

Taxpayers claiming the business expense deduction and the Manufacturers' Investment Credit (MIC) for the same property must reduce MIC qualified costs by the amount of the business expense deduction before computing the MIC. Taxpayers that elect to take the business expense deduction are not allowed to capitalize the expensed amount.

14500 Making the Election

References 17268(a); 17268(c); 24356.8(a); 24356.8(b)

EDAM 14510 Members of an Affiliated Group

The taxpayer must make an election to treat the cost of qualified property as a business expense, on the original return filed for the taxable year the property is first placed in service. The election must specify the items to which the election applies and the portion of the cost taken into account for purposes of determining the deduction amount. The election may not be revoked, unless the taxpayer has obtained the consent of the Franchise Tax Board.

The taxpayer makes the election by using:

- Form FTB 3807 – Local Agency Military Base Recovery Area Deduction and Credit Summary.

14510 Members of an Affiliated Group

References 24356.8(c)(5)-(6)

For purposes of electing the business expense deduction, all members of an affiliated group are treated as one taxpayer. The maximum deduction amount is properly apportioned among the members of the affiliated group.

An affiliated group is defined in IRC § 1504 as modified by the California Revenue & Taxation Code, to replace "at least 80%" with "more than 50%" each place it appears in IRC § 1504(a).

14600 Creating a Net Operating Loss

Unlike IRC § 179, there is *no* statutory prohibition on the amount of business expense deduction amount that may create a net operating loss.

14700 Alternative Minimum Tax

References 17062; 23457

The business expense deduction is *not* listed as a tax preference item.

14800 Recapture

References 17268(h); 24356.8(h): See also Cal. Code Regs. (CCR) §17267.2-1(a); 24356.7-1

EDAM 14810 Special LAMBRA Recapture

The business expense deduction is subject to recapture (added back to income) if, before the *close of the second taxable year after* the property is placed in service, the property is sold, disposed of, or is no longer used exclusively within the LAMBRA trade or business. The taxpayer is required to recapture the amount previously expensed for that item and include the amount as income for the taxable year in which the property ceases to be used. The basis of the property is increased as of the first day of the taxable year in which the recapture event occurs.

To recapture the amount deducted, add to the current year income, the amount previously deducted for that property.

Example: Corp. A purchases property on June 1, 1998 that qualifies Corp. A to take the LAMBRA business expense deduction. Corp. A's income year ends December 31 of each year. Corp. A disposes of the property August 5, 2000. The previous deduction is added to income in the 2000 tax year because the property was disposed of before the close of the second taxable year after the property was placed in service (12/31/2000). The basis in the asset would be increased by the recaptured amount effective January 1, 2000.

NOTE: The State Board of Equalization in an unpublished and (uncitable) decision agreed that the statute requires the closure of two taxable years after the end of the taxable year in which the property is placed in service and the election to claim the deduction on the original return is made. *Appeal of Accurate Metal Fabricators, Inc. 32552, Cal. St. Bd. Of Equal., July 3, 2000.*

14810 Special LAMBRA Recapture

References 17268(h); 17268(e)(2); 24356.8(h); 24356.8(d)(2)

See EDAM 12625.

Section 15000 LOCAL AGENCY MILITARY BASE RECOVERY AREA NET OPERATING LOSS

References 17276.1(a); 17276.5(a); 24416.1(a); 24416.5(a)

Taxpayers are required to annually report their income and expenses. Due to possible fluctuations in income and expenses, a taxpayer may have substantial profits in one year, while losses in another. In years where expenses exceed income, a net operating loss (NOL) occurs.

For each taxable year beginning on or after January 1, 1995, a qualified taxpayer engaged in a trade or business within a designated Local Agency Military Base Recovery Area (LAMBRA) may elect to carry forward 100% of its NOLs for a 15-year period.

A LAMBRA NOL cannot be generated until the first taxable year beginning on or after the area has been officially designated as a LAMBRA.

Prior to January 1, 1998, the applicable LAMBRA NOL code sections were:

- 17276 - 17276.1, 17276.2(c), 17276.3
- 24416 - 24416.1, 24416.2(c), 24416.3

For taxable years beginning on or after January 1, 1998, the LAMBRA NOL code sections are:

- 17276 - 17276.1, 17276.3, 17276.5
- 24416 - 24416.1, 24416.3, 24416.5

The following references in this chapter are to the new code section numbers.

15100 Geographic Boundaries and Designation Dates

For a listing of LAMBRAs, see "*LAMBRA Locations and Designation Dates*" EDAM 1320. To verify an address, refer to EDAM 1300.

15200 Qualified Taxpayer

References 17276.5(a); 17276.5(a)(3); 24416.5(a); 24416.5(a)(4)

EDAM 15210	Pass-Through Entities
EDAM 15211	S Corporations
EDAM 15212	Flow-through Losses
EDAM 15213	Net Increase in Jobs Requirement

For purposes of the LAMBRA NOL deduction, a qualified taxpayer includes a person or entity that is engaged in a trade or business within a LAMBRA and within the first two years of commencing business within the LAMBRA, has a net increase in jobs (defined as 2,000 paid hours per employee per year) of one or more employees in the LAMBRA (see EDAM 15213).

Taxpayers doing business in an area that was previously not a qualified area, but later designated as qualified, are allowed to utilize the special tax incentives for the taxable year beginning on or after the date the area is designated as a LAMBRA.

Further, the taxpayer, for the first two taxable years, must have a net increase in jobs of one or more employees in the LAMBRA and California. See EDAM 15213.

15210 Pass-Through Entities

In the case of any "pass-through entity", the determination of whether a taxpayer is a qualified taxpayer is made at the entity level.

15211 S Corporations

References 23802(d)(1)-(2)

For qualified taxpayers electing S corporation status *after* the designation of the LAMBRA, the qualified NOL attributed to the C corporation years cannot offset S corporation net income.

15212 Flow-through Losses

References 17087.5; 17087.6; 17851; 23800; 24271

The income and loss that will flow through to a shareholder, beneficiary, partner, or member, retains the same characteristics as it had with the pass-through entity.

The election (see EDAM 15300) to claim an NOL must be made by the entity and each investor on their respective returns. The election by the entity to utilize the LAMBRA NOL does not extend to, or bind the investor to utilizing the LAMBRA NOL. The investor may utilize the LAMBRA NOL if the entity utilized the general NOL provisions, or had no NOL. Each taxpayer must determine if they in fact have a NOL, and then decide whether the general or LAMBRA NOL will be utilized.

15213 Net Increase in Jobs Requirement

References 17276.5(a)(3); 24416.5(a)(4)

See EDAM 12625.

15300 Making the Election

References 17276.1(b); 17276.5(b); 17276.5(c); 17276.5(d); 24416.1(c); 24416.5(b); 24416.5(c); 24416.5(d)

Qualified taxpayers must make an election to claim the LAMBRA NOL. The election must be filed with the original return, timely filed, for the taxable year in which the NOL is incurred. The election is irrevocable.

If the taxpayer is eligible to qualify for an NOL under more than one section (operation in more than one economic development area, new small business etc.), the taxpayer must choose which section to elect. Taxpayers are prohibited from carrying over any other type of NOL from the same tax year other than the loss from the subdivision elected.

Failure to elect to compute the NOL deduction under Section 17276.1 or 24416.1 will cause the NOL to be subject to the limitations and restrictions under Section 17276 or 24416 (general NOL).

The taxpayer’s makes the election by using:

- Form FTB 3807 – Local Agency Military Base Recovery Area Deduction and Credit Summary.

In addition, the form FTB 3807 must be filed for each year in which the NOL deduction is taken.

15400 LAMBRA NOL Computation - General Provisions

References 17276.1; 17276.5(a)(4); 24416.1; 24416.5(a)(5)

A LAMBRA NOL is the loss attributable to the qualified taxpayer's business activities within a LAMBRA, prior to the LAMBRA expiration date. LAMBRA NOLs are determined under IRC § 172, as modified by CR&TC §17276.1, 17276.5, 24416.1, and 24416.5.

15410 LAMBRA NOL Limited by General NOL

References 17276; 24416

The LAMBRA NOL is compared to the NOL computed under the general NOL provisions of Section 17276 / 24416, *prior* to the 50% reduction. The LAMBRA NOL carryover is limited to the lesser of the LAMBRA NOL or the general NOL (prior to the 50% reduction). **NOTE:** If the LAMBRA NOL is limited by the general NOL amount, (prior to the 50% reduction), the amount can still be characterized as an LAMBRA NOL and allowed to be carried over at 100% for 15 years. An election must be made to characterize the NOL as a LAMBRA NOL.

Example: Corp. B incurred the following loss:

Income from business operations	$160,000
Interest from investment which is unrelated to Corp. B's business operations	15,000
Expenses of business operations	(189,000)
Net loss	**($14,000)**

To determine the NOL carryover attributed to the LAMBRA business operations, the following must be done:

1. Determine NOL per CR&TC § 24416 (prior to 50% reduction)
2. Determine NOL per CR&TC § 24416.5 (remove non-business items)

The NOL carryover is limited to the lesser of the general NOL (item 1) or the LAMBRA NOL (item 2) above.

1. CR&TC § 24416 "general" NOL - prior to 50% reduction

Net loss of Corp. B	($14,000)

2. CR&TC § 24416.5 LAMBRA NOL - exclude non-business income/loss

Income from operations	$160,000
Expenses of operations	(189,000)
Net loss of Corp. B (LAMBRA)	($29,000)

Pattern 1: Assume Corp. B operates entirely within the LAMBRA. Corp. B is allowed to carry over the lesser of the "general" NOL, or the LAMBRA NOL; in this case $14,000.

Pattern 2: Assume Corp. B conducts 40% of its total business operations in the LAMBRA. Because Corp. B only has 40% of its business operation in the LAMBRA, the $29,000 business loss must be apportioned before comparing it to the "general" NOL. In this example, the LAMBRA loss is $11,600 ($29,000 x 40%). Corp. B is allowed to carry over the lesser of the "general" NOL, or the LAMBRA NOL; in this case, $11,600.

15500 LAMBRA NOL - Loss Attributed to Business Activity

References 17276.5(a)(4); 24416.5(a)(5)

EDAM 15510	Property Factor – Loss Apportionment
EDAM 15520	Payroll Factor – Loss Apportionment
EDAM 15530	Apportionment – Combined Groups
EDAM 15540	Apportionment – Combined Groups
EDAM 15550	Apportioning for Personal Income Tax Taxpayers

A LAMBRA NOL is the loss attributable to the qualified taxpayer's business activities within a LAMBRA prior to the LAMBRA expiration date. Non-business income and/or loss are excluded from the calculation of the LAMBRA NOL.

If a business is located within and outside of a LAMBRA, the taxpayer must determine the portion of the total business loss that is attributable to the LAMBRA.

- Business loss is defined under the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA).
- Components of the factors are defined under the provisions of UDITPA.

For taxpayers conducting business operations within and without a LAMBRA, business loss is apportioned to the LAMBRA by multiplying the worldwide business loss by a fraction, the numerator of which is the property factor plus the payroll factor, and the denominator of which is two (2).

15510 Property Factor – Loss Apportionment

The property factor is a fraction.

- The numerator of the property factor is the average value of the real and tangible personal property owned or rented and used or available for use by the taxpayer *within the LAMBRA* during the taxable year.
- The denominator is the average value of all real and tangible personal property owned or rented and used or available for use during the taxable year *worldwide*.

Rented property is valued at eight (8) times the net annual rental rate. The net annual rental rate is the total rent paid for the property, less any subrental rates paid by subtenants.

15520 Payroll Factor – Loss Apportionment

The payroll factor is a fraction.

- The numerator of the payroll factor is the total compensation paid to the taxpayer's employees working within the LAMBRA during the taxable year.
- The denominator is the total compensation paid to employees working *worldwide* during the taxable year.

Example - Two-factor apportionment: For the taxable year ending 12/31/99, Corp. A operates within and outside an LAMBRA. Corp. A's business loss of $13,000 needs to be apportioned to the LAMBRA. The following amounts apply to Corp. A's property and payroll:

LAMBRA Property	$40,000
Worldwide (WW) Property	$100,000
LAMBRA Payroll	$5,000
WW Payroll	$10,000

LAMBRA Property/WW Property	=.40	
LAMBRA Payroll/WW Payroll	=.50	
	.90/2 = .45	LAMBRA Apportionment Factor

Business loss	$(13,000)
Apportionment Factor	x 0.45
LAMBRA NOL	$(5,850)

15530 Apportionment – Combined Groups

For members of a combined group, the LAMBRA NOL calculation will be based on the combined groups worldwide business loss (before CA apportionment). The numerator of the apportionment formula will be based on each LAMBRA taxpayer's separate LAMBRA payroll and property amounts, and the denominator will be based on the combined groups worldwide payroll and property amounts.

Example: For the taxable year ending 12/31/99, Parent Corporation A has two subsidiaries, B and C. Corporations A and B operate within an LAMBRA. The combined group operates within and outside California and apportions its income or loss to California using Schedule R. The combined group's business loss is $1,000,000.

Business loss apportioned to the LAMBRA was determined as follows:

	A	**B**	**C**	**Combined**
<u>Property Factor</u>				
LAMBRA Property	$2,000,000	$1,000,000	$0	$3,000,000
Worldwide Property				$5,000,000
Apportionment %	40%	20%		60%
Payroll Factor				
LAMBRA Payroll	$2,000,000	$800,000	$0	$2,800,000
Worldwide Payroll				$4,000,000
Apportionment %	50%	20%		70%
Average Apport. % (Property + Payroll Factors)/2	45%	20%		65%
Business Loss				$(1,000,000)
LAMBRA NOL	$(450,000)	$(200,000)		$(650,000)

15540 Apportionment – Combined Groups

For taxable years beginning on or after January 1, 1998: For members of a combined group, the limitation will be based on the intrastate apportioned business income for each taxpayer doing business within the LAMBRA. The numerator of the apportionment formula will be based on each LAMBRA taxpayer's separate LAMBRA property and payroll amounts and the denominator will be based on each LAMBRA taxpayer's separate California property and payroll amounts.

For taxable years beginning before January 1, 1998: For members of a combined group, the income limitation will be based on the combined groups worldwide business income (before CA apportionment). The numerator of the apportionment formula will be based on each LAMBRA taxpayer's separate LAMBRA payroll and property amounts, and the denominator will be based on the combined groups worldwide payroll and property amounts.

For an example of apportionment under this method refer to EDAM 23440 General Provisions - Income Apportionment.

Example: For the taxable year ending 12/31/1999, parent corporation A has two subsidiaries, B and C. Corporations A and B operate within the LAMBRA. The combined group operates within and outside California and apportions its income to California using Schedule R. The combined group's business income apportioned to California was $1,000,000. Corporation A and B's share of California business income is $228,000 and $250,000 respectively. Corporation A and B's separate LAMBRA and separate California property and payroll factor amounts are shown below.

Business income apportioned to the LAMBRA was determined as follows:

	A	**B**
<u>Property Factor</u>		
LAMBRA Property	$1,000,000	$ 800,000
California Property	$1,000,000	$1,200,000
Apportionment %	100%	66.66%
<u>Payroll Factor</u>		
LAMBRA Payroll	$800,000	$ 800,000
California Payroll	$800,000	$1,000,000
Apportionment %	100%	80%
Average Apport. % (Property + Payroll	100%	73.33%

Factors)/2

Apportioned Business Income	$228,000	$250,000
LAMBRA Income	$228,000	$183,333

15550 Apportioning for Personal Income Tax Taxpayers

The following examples show the application of the apportioning rules to personal income tax taxpayers.

Example: Ray Smith is vice president of an S corporation that has two locations, one within a LAMBRA and one outside the LAMBRA. Eighty percent (80%) of the S corporation's business is attributable to the LAMBRA. (NOTE: This percentage was determined by the S corporation, using Worksheet V from the FTB 3807 Business Booklet, at the time the S corporation return was prepared). Ray divides his time equally (50% & 50%) between the two offices of the S corporation.

Mary Smith (Ray's spouse) works for the S corporation at its office located in the LAMBRA.

Ray and Mary Smith have the following 1999 items of California income and expense:

Ray's salary from the S corp.	$100,000
Mary's salary from the S corp.	75,000
Interest on savings account	1,000
Dividends	3,000
Schedule K-1 (100S) from the S corp.	
Ordinary Loss	200,000
LAMBRA business expense deduction	(5,000)*
Ray's unreimbursed employee expenses from Schedule A	(2,000)

*The LAMBRA business expense deduction is a separately stated item on Schedule K-1 (100S).

The Smith's LAMBRA loss is computed as follows:

Ray's LAMBRA salary ($100,000 x 50%)	$50,000
Mary's LAMBRA salary ($75,000 x 100%)	75,000
Pass-through ordinary loss from the S-Corp. ($200,000 x 80%)	(160,000)
LAMBRA business expense deduction from the S-Corp.	(5,000)
Ray's unreimbursed employee business expenses (2,000 x 50%)	(1,000)
Total LAMBRA loss	$(41,000)

NOTE: The standard deduction and personal or dependency exemptions are not included in the computation of the LAMBRA NOL since they are not related to trade or business activities.

15600 Carryover / Carryback

References 17276.1(a); 17276.5(a); 24416.1(a); 24416.5(a)

For each taxable years beginning on or after January 1, 1995, a qualified taxpayer engaged in a trade or business within a designated LAMBRA may elect to carryover 100% of its LAMBRA NOLs. No NOL carrybacks are allowed.

The NOLs may be carried over to each of the 15 taxable years following the year of loss, or until exhausted, whichever occurs first. If an NOL carryover remains after the LAMBRA designation has expired, the LAMBRA shall be deemed to remain in existence for purposes of computing the LAMBRA income limitation, and for purposes of allowing the LAMBRA NOL deduction.

NOTE: Financial institutions, as defined in IRC § 585, 586, or 593, using bad debt reserve methods may carry the loss forward for a maximum of 5 taxable years.

15700 LAMBRA NOL Deduction - General Provisions

References 17276.5(a)(5); 17276.5(a)(6)(B); 24416.5(a)(6); 24416.5(a)(7)(B)

EDAM 15710	Business Income Activity Limitation
EDAM 15711	Property Factor – Income Apportionment
EDAM 15712	Payroll Factor – Income Apportionment
EDAM 15713	Apportioning for Personal Income Tax Taxpayers

The LAMBRA NOL deduction can only *offset business income attributable to operations of the taxpayer within the designated LAMBRA*.

In the event that a LAMBRA NOL deduction is allowable for any taxable year after the LAMBRA designation has expired, the LAMBRA will be deemed to remain in existence for the purpose of computing the business income limitation.

15710 Business Income Activity Limitation

References 17276.5(a)(6); 24416.5(a)(7)

If a business is located within and outside of a LAMBRA, the taxpayer must determine the portion of the California business income that is attributable to the LAMBRA.

- Business income is defined under the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA).
- Components of the factors are defined under the provisions of UDITPA.

For taxable years beginning on or after January 1, 1998, business income shall be apportioned to the LAMBRA by multiplying the taxpayer's total California source business income by a fraction, the numerator of which is the property factor plus the payroll factor, and the denominator of which is two (2).

For taxable years beginning before January 1, 1998, business income is apportioned to the LAMBRA by multiplying the worldwide business income by a fraction, the numerator of which is the property factor plus the payroll factor, and the denominator of which is two (2).

15711 Property Factor – Income Apportionment

The property factor is a fraction. The numerator of the property factor is the average value of the real and tangible personal property owned or rented and used or available for use by the taxpayer *within the LAMBRA* during the taxable year.

- For taxable years beginning on or after January 1, 1998, the denominator is the average value of all real and tangible personal property owned or rented and used or available for use by the taxpayer during the taxable year *within California*.
- For taxable years beginning before January 1, 1998, the denominator is the average value of all real and tangible personal property owned or rented and used or available for use during the taxable year *worldwide.*

Rented property is valued at eight (8) times the net annual rental rate. The net annual rental rate is the total rent paid for the property, less any subrental rates paid by subtenants.

15712 Payroll Factor – Income Apportionment

The payroll factor is a fraction. The numerator of the payroll factor is the total compensation paid to the taxpayer's employees working within the LAMBRA during the taxable year.

- For taxable years beginning on or after January 1, 1998, the denominator is the total compensation paid to employees working for the taxpayer *in California* during the taxable year.
- For taxable years beginning before January 1, 1998, the denominator is the total compensation paid to employees working *worldwide* during the taxable year.

Example **-** Two-factor apportionment: For the taxable year ending 12/31/99, Corp. A operates within and outside a LAMBRA. California business income of $13,000 needs to be apportioned to the LAMBRA. The following amounts apply to Corp. A's property and payroll:

LAMBRA Property	$40,000
CA Property	$100,000
LAMBRA Payroll	$5,000
CA Payroll	$10,000

LAMBRA Property/CA Property	=.40	
LAMBRA Payroll/CA Payroll	=.50	
	.90/2 = .45	LAMBRA Apportionment Factor

Business income	$13,000
Apportionment Factor	x 0.45
LAMBRA Business Income	$5,850

15713 Apportioning for Personal Income Tax Taxpayers

The following examples show the application of the apportioning rules to personal income tax taxpayers.

Example: Ray Smith is vice president of an S corporation that has two locations, one within a LAMBRA and one outside the LAMBRA. Eighty percent (80%) of the S corporation's business is attributable to the LAMBRA. (NOTE: This percentage was determined by the S corporation, using Worksheet V from the FTB 3807 Business Booklet, at the time the S corporation return was prepared). Ray divides his time equally (50% & 50%) between the two offices of the S corporation.

Mary Smith (Ray's spouse) works for the S corporation at its office located in the LAMBRA.

Ray and Mary Smith have the following 1999 items of California income and expense:

Ray's salary from the S corp.	$100,000
Mary's salary from the S corp.	75,000
Interest on savings account	1,000
Dividends	3,000
Schedule K-1 (100S) from the S corp.	
Ordinary income	40,000
LAMBRA business expense deduction	(5,000)*
Ray's unreimbursed employee expenses from Schedule A	(2,000)

*The LAMBRA business expense deduction is a separately stated item on Schedule K-1 (100S).

The Smith's LAMBRA income is computed as follows:

Ray's LAMBRA salary ($100,000 x 50%)	$50,000
Mary's LAMBRA salary ($75,000 x 100%)	75,000
Pass-through ordinary income from the S-Corp. ($40,000 x 80%)	32,000
LAMBRA business expense deduction from the S-Corp.	(5,000)
Ray's unreimbursed employee business expenses (2,000 x 50%)	(1,000)
Total LAMBRA income	$151,000

NOTE: The standard deduction and personal or dependency exemptions are not included in the computation of LAMBRA income since they are not related to trade or business activities.

15800 NOL Suspensions

References 17276.3(c); 24416.3(c)

NOTE: For taxable years beginning in 2002 and 2003, California has suspended the Net Operating Loss (NOL) carryover deduction. Taxpayers may continue to compute and carryover an NOL during the suspension period. The carryover period for suspended losses is extended by two years for losses incurred before January 1, 2002 and by one year for losses incurred after January 1, 2002 and before January 1, 2003. The deduction for disaster losses is not affected by the NOL suspension rules.

15900 Alternative Minimum Tax

References 17062; 23456

Taxpayers claiming a LAMBRA NOL deduction must also determine their NOL for alternative minimum tax purposes.

Section 16000 MANUFACTURING ENHANCEMENT AREA HIRING CREDIT

References 17053.47(a); 17053.47(b)(5)(B); 23622.8(a); 23622.8(b)(5)(B)

For each taxable year beginning on or after January 1, 1998, the California Revenue and Taxation Code (CR&TC) provides a hiring credit for "qualified" taxpayers who operate or invest in a business located within a designated Manufacturing Enhancement Area (MEA) and hire "qualified employees" and pay them "qualified wages". MEAs were established in California to stimulate development in selected economically depressed areas.

The MEA hiring credit applies to those employees hired after the designation date of the MEA (October 1, 1998).

16100 Geographic Boundaries and Designation Dates

For a listing of MEAs, see "*MEA Locations and Designation Dates*" EDAM 1330. To verify an address, refer to EDAM 1300.

16200 Qualified Taxpayer

References 17053.47(b)(6); 23622.8(b)(6)

A *qualified taxpayer* is any taxpayer engaged in a trade or business within an MEA and who meets all of the following requirements:

- Is engaged in those lines of business described in Codes 2011 to 3999, inclusive, of the *Standard Industrial Classification (SIC) Manual* published by the United States Office of Management and Budget, 1987 edition;
- At least 50 percent of the qualified taxpayer's work force hired after the designation of the MEA, is composed of individuals who, at the time of hire, are residents of the county in which the MEA is located; and
- Of this 50 percent of local hires, at least 30 percent were qualified disadvantaged individuals.

16210 Pass-Through Entities

The determination of whether a taxpayer is a qualified taxpayer is made at the entity level. The term "pass-through entity" means any partnership or S corporation. The hiring credit is allowed to the pass-through entity and passed through to the partners or shareholders.

16220 Controlled Groups

References 17053.47(c)(1)(A); 17053.47(c)(1)(C); 23622.8(c)(1)(A); 23622.8(c)(1)(C)
All employees of trades or businesses that are under common control, or members of the same controlled group of corporations, are treated as employed by a single taxpayer.

A controlled group of corporations is defined in IRC § 1563(a) as modified by the California Revenue & Taxation Code, to replace *"at least 80%"* with *"more than 50%"*. The determination is made without regard to subsections (a)(4) and (e)(3)(C) of IRC § 1563.

NOTE: Controlled groups of taxpayers may not transfer employees between members to trigger or increase the credit.

16230 Acquired Businesses

References 17053.47(c)(2); 23622.8(c)(2)

For purposes of the hiring credit, if a major portion of a business is acquired from another employer, the employment relationship between the employee and the new employer shall not be treated as terminated if the employee continues employment in that business. Also, if a major portion of a separate unit of a business predecessor is acquired, the employment relationship between the employee and the new employer is not treated as terminated if the employee continues employment in that business.

NOTE: The new employer, “steps into the shoes” of the old employer for purposes of incurring future credits.

16300 Qualified Wages

References 17053.47(b)(1); 17053.47(b)(2); 17053.47(e); 23622.8(b)(1); 23622.8(b)(2)

Qualified wages are wages paid or incurred to employees (qualified) during the consecutive 60-month period beginning with the first day the employee commences employment with the taxpayer. For qualified employees hired before the expiration date of the MEA, qualified wages paid or incurred within the 60-month period beginning with the first day the employee commences employment with the taxpayer shall continue to qualify for the credit after the area expiration date, as if the MEA designation were still in existence and binding.

Qualified *wages* means that portion of hourly wages that does not exceed 150% of the minimum wage.

- Minimum wage means the wage established by the Industrial Welfare Commission. When the California minimum wage is higher than federal minimum wage, use the California minimum wage for purposes of this credit.
- To determine a salaried employee's hourly wage, divide the total salary by the average hours worked, normally 2,000 hours per year.

16310 Estates and Trusts

In the case of an estate or trust, apportion the qualified wages between the estate/trust and the beneficiaries on the basis of the income allocable to each. Consequently, any beneficiary, to whom wages are apportioned, is treated as the employer with respect to those wages.

16320 Non-Qualified Wages

Qualified wages *do not* include any wages paid or incurred on or after the area expiration date except as noted previously for qualified employees hired prior to the expiration of the MEA.

16330 Minimum Wage Chart

EFFECTIVE DATE	MINIMUM WAGE	MAXIMUM HOURLY WAGE (150% of Minimum Wage)
March 1, 1998 to December 31, 2000	$5.75	$8.62
January 1, 2001 to December 31, 2001	$6.25	$9.37
January 1, 2002 to Current	$6.75	$10.12

16340 Annual Wage Limitation

The total amount of qualified wages taken into account for purposes of claiming the credit shall not exceed two million dollars ($2,000,000) each taxable year.

16400 Qualified Employee

References 17053.47(b)(5); 23622.8(b)(5)

EDAM 16410 Seasonal Employees
EDAM 16420 Leased Employees

A *qualified employee* is an individual who satisfies all of the following:

ANNUAL TESTS
- At least 90% of the employee's work for the taxpayer, during the taxable year, must be directly related to the conduct of the taxpayer's trade or business located in the MEA; **and**
- At least 50 percent of the employee's services for the taxpayer, during the taxable year, must be performed within the boundaries of the MEA;

TIME OF HIRE TESTS
- The employee is hired after the area was designated as a MEA; and
- Immediately preceding commencement of employment with the taxpayer, the employee is any of the following:
  - Eligible for services under the federal Job Training Partnership Act (JTPA) or its successor;
  - Registered under the Greater Avenues for Independence (GAIN) Act of 1985, or its successor; **or**
  - Certified eligible by the Employment Development Department under the federal Targeted Jobs Credit Program (TJTC), or its successor, whether or not this program is in effect.

16410 Seasonal Employees

References 17053.47(b)(1)(C); 17053.47(b)(7); 23622.8(b)(1)(C); 23622.8(b)(7)
"Seasonal employment" means employment that has regular and predictable substantial reductions in business operations.

Reemployment of an individual, in connection with any increase (including a regularly occurring seasonal increase) in business operations, does not constitute commencement of employment for purposes of the MEA hiring credit.

16420 Leased Employees

The "employer" is the qualified taxpayer and may qualify for the hiring credit for leased employees. The employer can be either the leasing company or the subscriber to the leasing company. Generally, the employer has the legal obligation to pay the payroll taxes of the employee, and has the right to control and direct the workers (employee's) services.

Internal Revenue Service (IRS) Publication 15-A, *Employer's Supplemental Tax Guide* provides guidelines for establishing an employment relationship and provides examples to consider in determining the employer-employee relationship.

16500 Credit Computation

References 17053.47(a); 17053.47(b)(1)(B); 23622.8(a); 23622.8(b)(1)(B)

For each taxable year beginning on or after January 1, 1998, a hiring credit is allowed to a qualified taxpayer for hiring a qualified employee for employment within the MEA. The credit is equal to the sum of each of the following:

- 50% of the qualified wages during the first year of employment.
- 40% of the qualified wages during the second year of employment.
- 30% of the qualified wages during the third year of employment.
- 20% of the qualified wages during the fourth year of employment.
- 10% of the qualified wages during the fifth year of employment.

The total amount of qualified wages used to compute the MEA hiring credit cannot exceed $2,000,000 per each taxable year.

The credit percentage is based on the employee's date of employment and subsequent anniversary dates. The taxpayer's tax year does not control the applicable credit percentages. With the exception of the first and last year of the credit, within one tax year, two percentage ranges for the computation of the credit may apply.

> ***Example***: An employee was hired 12/1/1998, and the taxpayer is completing the tax return for the year ending 12/31/1999. For the period 1/1/1999 to 11/30/1999, the hiring credit is based on 50% of qualified wages. For the period 12/1/1999 to 12/31/1999, the hiring credit is based on 40% of qualified wages.

Once the employee commences employment, the credit percentage range begins and generally is not interrupted in the event of a subsequent layoff and rehire of the employee.

Example: An employee is hired 12/1/1998, is temporarily laid off 2/1/1999, and is rehired 4/1/1999. The 50% credit range runs from 12/1/1998 to 11/30/1999 regardless of the layoff period between 2/1/1999 and 3/31/1999.

16510 Exclusive Credit

References 17053.47(i); 23622.8(h)

If the qualified taxpayer is allowed the MEA hiring credit for qualified wages paid to an employee, only that one credit is allowed to the taxpayer with respect to those qualified wages for that employee.

16520 Reduction for Other Tax Credits

References 17053.47(f); 23622.8(e)

The MEA hiring credit is reduced by the credits allowed under California Revenue & Taxation Code Section 17053.7 & 23621 (Jobs Tax Credit), and the federal credit allowed under IRC § 51 (Work Opportunity Tax Credit – WOTC).

NOTE: California conformed to IRC § 51 (as codified on 1/1/2001) for taxable years beginning on or after 1/1/2002. Thus, the WOTC will reduce the hiring credit for employees hired on or before 12/31/2001 (see IRC § 51(c)(4)). In prior years, California conformed to IRC § 51 for taxable years beginning on or after 1/1/1998. Thus, the WOTC reduced the hiring credit for employees hired on or before 6/30/1998 (see IRC § 51(c)(4)).

16530 Wage Expense Reduction

References 17053.47(f); 23622.8(e)

The taxpayer must reduce any deduction for wages by the amount of the MEA hiring credit allowed (including any current year credit to be carried forward).

16540 Business Income Activity Limitation

References 17053.47(h)(2); 23622.8(g)(2)

The amount of the hiring credit claimed, including any credit carryover from prior years, may not exceed the amount of tax on the taxpayer's MEA business income in any year. Depending on the tax year involved, the MEA business income is that portion of the taxpayer's *California source* business income or the worldwide income that is apportioned to the MEA. Non-business income or loss is not included in the calculation of business income from the MEA. Each taxpayer claiming the credit must compute the MEA business income and resulting tax.

Example: Corp. A operates entirely within an MEA. In order to determine the amount of hiring credit allowable, the business income and the tax on that business income must be determined. Corp. A has the following items of income and expense:

Income from business operations	$30,000
Interest from investment which is unrelated to Corp. A's business operations	2,000
Business expenses	(17,000)
Net taxable income before taxes	**$15,000**

Corp. A's income attributed to business operations is:

Income from business operations	$30,000
Business expenses	(17,000)
Net Business Income	**$13,000**

To determine the MEA hiring credit allowable, the net business income is multiplied by the current tax rate.

Net Business Income	$13,000
x 8.84%	x .0884
Tax associated with business income	$1,149

In this example, the taxpayer can offset the tax of $1,149 with the hiring credit available (up to $1,149).

NOTE: "net tax"/"tax" and alternative minimum tax impose limitations on the allowable offset but were not considered a factor in this example.

16550 General Provisions – Apportionment of Business Income

References 17053.47(h)(2); 17053.47(h)(3); 23622.8(g)(2); 23622.8(g)(3)

If a business is located within and outside of the MEA, the taxpayer must determine the portion of the total business income attributable to the MEA.

- Business income is defined under the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA).
- Components of the factors are defined under the provisions of UDITPA.

Business income is apportioned to the MEA by multiplying the taxpayer's *California* source business income by a fraction, the numerator of which is the property factor plus the payroll factor, and the denominator of which is two (2).

16551 Property Factor – Income Apportionment

The property factor is a fraction. The numerator of the property factor is the average value of the real and tangible personal property owned or rented and used or available for use by the taxpayer *within the MEA* during the taxable year. The denominator is the average value of all real and tangible personal property owned or rented and used or available for use by the taxpayer during the taxable year *within California*.

Rented property is valued at 8 times the net annual rental rate. The net annual rental rate is the total rent paid for the property, less any subrental rates paid by subtenants.

16552 Payroll Factor – Income Apportionment

The payroll factor is a fraction. The numerator of the payroll factor is the total compensation paid to employees working for the taxpayer *within the MEA* during the taxable year. The denominator is the total compensation paid to employees working for the taxpayer *within California* during the taxable year.

Example: Corp. A operates within and outside the MEA. California business income of $13,000 needs to be apportioned to the MEA. The following amounts apply to Corp. A's property and payroll:

MEA Property	$40,000
CA Property	$100,000
MEA Payroll	$5,000
CA Payroll	$10,000

MEA Property/CA Property	= .40	
MEA Payroll/CA Payroll	= .50	
	.90/2 = .45	MEA Apportionment Factor

Business income	$13,000
Apportionment Factor	x 0.45
MEA Business Income	$5,850
Current Tax Rate	x .0884
Tax attributable to MEA business income	$ 517

16553 Apportionment – Combined Groups

For members of a combined group, the limitation is based on the intrastate apportioned business income for each taxpayer doing business within the MEA. The numerator of the apportionment formula is based on each MEA taxpayer's separate MEA property and payroll amounts and the denominator is based on each MEA taxpayer's separate California property and payroll amounts.

Example: For the taxable year ending 12/31/99, parent corporation A has two subsidiaries, B and C. Corporations A and B operate within the MEA. The combined group operates within and outside California and apportions its income to California using Schedule R. The combined group's business income apportioned to California was $1,000,000. Corporation A and B's share of California business income is $228,000 and $250,000 respectively. Corporation A and B's separate MEA and separate California property and payroll factor amounts are shown below.

Business income apportioned to the MEA was determined as follows:

	A	**B**
<u>Property Factor</u>		
MEA Property	$1,000,000	$ 800,000
California Property	$1,000,000	$1,200,000
Apportionment %	100%	66.66%
<u>Payroll Factor</u>		
MEA Payroll	$800,000	$ 800,000
California Payroll	$800,000	$1,000,000
Apportionment %	100%	80%
Average Apport. % (Property + Payroll Factors)/2	100%	73.33%
Apportioned Business Income	$228,000	$250,000
MEA Income	$228,000	$183,333

16554 Apportioning for Personal Income Tax Taxpayers

The following examples show the application of the apportioning rules to personal income tax taxpayers.

Example: Ray Smith is vice president of an S corporation that has two locations, one within the MEA and one outside the MEA. Eighty percent (80%) of the S corporation's business is attributable to the MEA. (**NOTE**: This percentage was determined by the S corporation, using Worksheet II from the FTB 3808 Business Booklet, at the time the S corporation return was prepared). Ray divides his time equally (50% & 50%) between the two offices of the S corporation.

Mary Smith (Ray's spouse) works for the S corporation at its office located in the MEA.

Ray and Mary Smith have the following 1999 items of California income and expense:

Ray's salary from the S corp.	$100,000
Mary's salary from the S corp.	75,000
Interest on savings account	1,000
Dividends	3,000
Schedule K-1(100S) from the S corp.	
Ordinary income	40,000
MEA business expense deduction	(5,000)*
Ray's unreimbursed employee expenses from Schedule A	(2,000)

*The MEA business expense deduction is a separately stated item on Schedule K-1 (100S).

The Smith's MEA income is computed as follows:

Ray's MEA salary ($100,000 x 50%)	$50,000
Mary's MEA salary ($75,000 x 100%)	75,000
Pass-through ordinary income from the S-Corp. ($40,000 x 80%)	32,000
MEA business expense deduction from the S-Corp.	(5,000)
Ray's unreimbursed employee business expenses (2,000 x 50%)	(1,000)
Total MEA income	**$151,000**

Ray and Mary must compute the tax on the total MEA income of $151,000 (as if it represents all of their income). Using the tax rate schedule for the filing status *married* *filing joint*; the 1999 tax on $151,000 is $10,659. The $10,659 is the first limitation on MEA credits for the 1999 tax year. The second limitation on the credits is the *net tax* on all income.

NOTE: The standard deduction and personal or dependency exemptions are not included in the computation of MEA income since they are not related to trade or business activities.

Example: John Doe is the President and shareholder of an S corporation with one location operating entirely within the MEA. John receives a salary of $50,000 from the corporation. John's CA AGI is made up of the following items:

S corporation salary	$50,000
Interest on Savings Account	5,000
Dividends	2,000
Capital Gain	10,000
S corp. ordinary loss from Schedule K-1(100S)	(60,000)
CA AGI	$7,000

John's MEA income is computed as follows:

S corporation salary	$50,000
S corporation ordinary loss	(60,000)
Total MEA income/(loss)	$(10,000)

John's MEA hiring credit from Schedule K-1 (100S) totals $3,000. Since John has negative MEA income, he cannot use the MEA hiring credit. The hiring credit claimed cannot exceed the amount of tax on the MEA business income in any year. However, carryover of the unused credit would be allowed.

16560 S Corporations

References 17053.47(f); 23622.8(e); 23803(a)(1)(A); 23803(a)(1)(F)

An S corporation's hiring credit may reduce the MEA tax at both the corporate and shareholder levels. However, the S corporation may only use one-third (1/3) of the credit to reduce the tax on the S corporation's MEA income.

One hundred percent (100%) of the MEA credit is passed through to the S corporation shareholders. The full amount of the credit is reported on Schedule K (100S) and passed through to the shareholders on Schedules K-1 (100S).

The wage reduction for the S corporation is equivalent to the 1/3 credit amount. The wage reduction for the shareholders is 100% of the credit amount, equal to the amount of credit passing through to them.

Example: An S corporation computes a $3,000 hiring credit. The S corporation's credit is $1,000 and the wage reduction is $1,000. The $3,000 credit is passed through to the S corporation's shareholders, and the wage reduction recognized by the shareholders is $3,000.

16600 Credit Usage & Carryover

The total amount of the MEA credit, including any credit carryover from prior years, that may reduce the "net tax"/"tax" for the taxable year, shall not exceed the amount of tax imposed on the taxpayer's business income attributable to the MEA, determined as if that income represented all of the income of the taxpayer.

The portion of the credit that exceeds the "net tax"/"tax" for the taxable year, may be carried over and added to the credit, if any, in the following year. The credit may be carried over to succeeding years, until it is exhausted.

If a credit carryover remains after the MEA has expired, is no longer binding, or becomes inoperative, the MEA shall be deemed to remain in existence for purposes of computing the taxpayer's business income attributable to the MEA.

Example: A taxpayer has a $4,900 MEA hiring credit. Tax imposed on MEA business income is $4,700, and the taxpayer's overall "net tax"/"tax" is $4,000. The taxpayer would be eligible to claim a $4,000 maximum hiring credit.

Total MEA hiring credit	$4,900
Tax on MEA income	$4,700
First limitation:	
Lesser of total credit or tax on MEA income	$4,700
Second limitation:	
Lesser of tax on MEA Income or "*net tax*"/"*tax*"	$4,000
Maximum credit allowed:	
Lesser of *MEA tax limitation* or "*net tax*"/"*tax*" *limitation*	$4,000
Total hiring credit	$4,900
Maximum credit allowed	$4,000
Carryover	$ 900

16610 Credit Will Not Reduce Certain Taxes

The MEA hiring credit cannot reduce the:

- Minimum franchise tax (corporations, limited partnerships, limited liability partnerships, LLCs, and S corporations);
- Annual tax (partnerships, LLCs classified as partnerships and Q-Subs).
- Built-in gains tax (S corporations);
- Excess net passive income tax (S corporation);
- Alternative minimum tax (corporations, exempt organizations, individuals and fiduciaries); or
- Regular tax below tentative minimum tax.

16620 Credit Recapture

References 17053.47(d)(1)(A); 17053.47(d)(1)(B); 17053.47(d)(3); 23622.8(d)(1)(A); 23622.8 (d)(1)(B); 23622.8 (d)(3)

16621 Non-Seasonal Employees

Recapture of the hiring credit is required if the employee is terminated before the end of the longer of the following two periods:

- The first 270 "days of employment" (whether or not consecutive); or
- Ninety (90) "days of employment" plus 270 calendar days.

To recapture the credit, the taxpayer must add to the current year's tax the amount of credit claimed for the year of termination, as well as all prior year credit claimed for the terminated employee.

16622 Seasonal Employees

For taxable years beginning on or after January 1, 1998, for seasonal employees, the taxpayer must recapture the amount of the credit if employment is terminated before the completion of 270 "days of employment" during the 60-month period beginning the day the employee commences employment with the taxpayer except as subsequently discussed.

To recapture the credit, the taxpayer must add the amount of credit previously claimed in all years to the tax for the tax year that includes the 60^{th} month of employment.

A ‘‘day of employment’’ includes any day the employee was paid to work, regardless of whether the employee actually worked (including paid holidays, sick days, and vacation days).

NOTE: Any increase in tax, due to credit recapture, cannot be offset by the current year hiring credit.

16623 Credit Recapture – Exceptions

References 17053.47(d)(2)(A); 17053.47(d)(2)(B); 23622.8(d)(2)(A); 23622.8(d)(2)(B)
For both regular and seasonal employees, the credit recapture will not apply if the termination was:

- Voluntary on the part of the employee;
- Caused by the employee becoming disabled;
- Due to employee misconduct;
- Due to a substantial reduction in business; or
- In order to enable other qualified employees to be hired, creating an increase in the number of qualified employees and the hours of employment.

16624 Change in the Form of the Trade or Business

References 17053.47(d)(2)(C); 23622.8(d)(2)(C)

The employment relationship between the taxpayer and an employee is not treated as terminated by reason of a mere change in the form of conducting the trade or business. If the employee continues employment in that trade or business and the taxpayer retains a substantial interest in that trade or business, the employee is not treated as terminated. In addition, transactions in which IRC § 381(a) applies will not trigger recapture if the employee continues to be employed by the acquiring corporation.

16700 Record Keeping Requirements

For each qualified employee, documentation should be kept showing the following:

- Employee name
- Date employee was hired
- Number of hours the employee worked for each month of employment
- Wage rate paid for each month of employment
- Schedule calculating the hiring credit
- Overtime hours
- Location where services were performed
- Date employee was terminated, and reason why

Section 17000 LOS ANGELES REVITALIZATION ZONE HIRING CREDIT

References (Repealed Sections) 17053.10(a); 17053.10(b)(5); 17053.17(a); 23623.5(a); 23625(a); 23625(b)(5)

The Los Angeles Revitalization Zone (LARZ) was established to aid economic development in areas that suffered damage during the civil unrest that occurred in the County of Los Angeles during April and May 1992. The LARZ became operative on May 1, 1992, and applied to businesses with taxable or income years beginning on or after January 1, 1992. The LARZ expired on December 1, 1998.

The California Revenue and Taxation Code (CR&TC) provided two hiring credit incentives for taxpayers conducting business activities within the LARZ. These incentives are the *General Hiring Credit* and the *Construction Hiring Credit*. In general, these two incentives provide for a credit based upon a declining percentage of qualified wages paid to or incurred for qualified employees.

No new LARZ hiring credits may be generated in taxable or income years beginning on or after January 1, 1998. However, LARZ hiring credit carryovers may still be claimed for 15 years from the year the credit was generated.

- The *General Hiring Credit* is available, for taxable or income years beginning on or after January 1, 1992, and before January 1, 1998, for hiring, on or after May 1, 1992, qualified disadvantaged individuals.

- The *Construction Hiring Credit* is available, for taxable or income years beginning on or after January 1, 1992, and until December 31, 1997, for employing, on or after May 1, 1992, qualified employees. The LARZ *Construction Hiring Credit* requires that the employee be hired to perform construction work within the LARZ. Construction work means any work performed by a qualified employee related directly to the erection, demolition, repair, or renovation of a structure located within the LARZ.

No new LARZ credits may be generated in taxable or income years beginning on or after January 1, 1998. However, LARZ credit carryovers may still be claimed for 15 years from the year the credit was generated.

Taxpayers that receive a LARZ *General Hiring Credit* or *Construction Hiring Credit* in their taxable or income year beginning on or after January 1, 1998, from a 1997 fiscal year pass-through entity *may not* claim these credits in their taxable or income year beginning on or after January 1, 1998. These credits can only be claimed for taxable or income years beginning *before* January 1, 1998.

17100 Geographic Boundaries

For a listing of LARZ cities, see "LARZ *Locations and Designation Dates*" EDAM 1350. To verify an address, refer to EDAM 1300.

NOTE: Effective 1/1/96, the LARZ geographic area was re-determined (downsized) to eliminate previously qualified addresses. For taxpayers that operate in the portion of the LARZ that was excluded when the LARZ was downsized, LARZ benefits that were incurred when the LARZ designation was effective are allowed after downsizing (carryover amounts). In regards to the applicability of LARZ benefits incurred after the downsize of the LARZ, the hiring credit is no longer available, for income or taxable year beginning on or after 1/1/96 (determination date) for employees hired on or after 1/1/96. For employees hired before 1/1/96, the hiring credit continues for these employees assuming all other qualifying tests are met until expiration of the hiring credit provision.

17200 Taxpayer Defined – General & Construction Hiring Credits

References (Repealed Sections) 17053.10(b)(6); 17053.17(b)(7); 23623.5(b)(7); 23625(b)(6)

EDAM 17210	Controlled Groups - General Hiring Credit Only
EDAM 17220	Acquired Businesses
EDAM 17230	Change in the Form of the Trade or Business
EDAM 17240	S Corporations

"Taxpayer" means a person or entity engaged in a trade or business within the LARZ.

17210 Controlled Groups - General Hiring Credit Only

References (Repealed Sections) 17053.17(b)(9)(A); 23623.5(b)(9)(A); 23623.5(b)(9)(C)

All employees of trades or businesses that are under common control, or members of the same controlled group, are treated as employed by a single taxpayer.

A controlled group of corporations is defined in IRC § 1563(a) as modified by the California Revenue & Taxation Code, to replace "*at least 80%*" with "*more than 50%*". The determination shall be made without regard to subsections (a)(4) and (e)(3)(C) of IRC § 1563.

NOTE: Controlled groups of taxpayers may not transfer employees between members to trigger or increase the credit.

17220 Acquired Businesses

References (Repealed Sections) 17053.10(c); 17053.17(b)(10); 23623.5(b)(10); 23625(c)

For purposes of the hiring credit, if a major portion of a business is acquired from another employer, the employment relationship between the employee and the new employer is not treated as terminated if the employee continues employment in that business. Also, if a major portion of a separate unit of a business predecessor is acquired, the employment relationship between the employee and the new employer is not treated as terminated if the employee continues employment in that business.

NOTE: The new employer, “steps into the shoes” of the old employer for purposes of incurring future credits.

17230 Change in the Form of the Trade or Business

References (Repealed Sections) 17053.10(h)(2)(B); 17053.17(c)(2)(B); 23623.5(c)(2)(B); 23625(h)(2)(B)

The employment relationship between the taxpayer and an employee is not treated as terminated by reason of a mere change in the form of conducting the trade or business. If the employee continues employment in that trade or business and the taxpayer retains a substantial interest in that trade or business, the employee is not treated as terminated. In addition, transactions in which IRC § 381(a) applies will not trigger recapture if the employee continues employment by the acquiring corporation.

17240 S Corporations

References 23803(a)(1)(A); 23803(a)(1)(F); (Repealed Sections) 17053.10(e); 17053.17(e); 23623.5(e); (e)

An S corporation's hiring credit may reduce the LARZ tax at both the corporate and shareholder levels. However, the S corporation may only use one-third (1/3) of the credit to reduce the tax on the S corporation's LARZ income.

One hundred percent (100%) of the LARZ hiring credits are passed through to the S corporation shareholders. The full amount of the credits are reported on Schedule K (100S) and passed through to the shareholders on Schedules K-1 (100S).

The wage reduction for the S corporation is equivalent to the 1/3 credit amount. The wage reduction for the shareholders is 100% of the credit amount, equal to the amount of credit passing through to them.

Example: An S Corporation computes a $3,000 hiring credit. The S corporation's credit is $1,000 and the wage reduction is $1,000. The $3,000 credit is passed through to the S corporation's shareholders, and the wage reduction recognized by the shareholders is $3,000.

17300 General Hiring Credit

17310 Qualified Wages

References (Repealed Sections) 17053.17(b)(1)-(2); 17053.17(b)(8); 17053.17(d); 23623.5(b)(1)-(2); 23623.5(b)(8

Qualified wages are wages paid or incurred to qualified employees during the consecutive 60-month period beginning with the first day the employee commences employment with the taxpayer.

In general, *qualified wages* means that portion of hourly wages that does not exceed 150% of the minimum wage.

- Minimum wage means the wage established by the Industrial Welfare Commission. When the California minimum wage is higher than federal minimum wage, use the California minimum wage for purposes of this credit.
- To determine a salaried employee's hourly wage, divide the total salary by the average hours worked, normally 2,000 hours per year.

17311 Non-Qualified Wages

Qualified wages *do not* include any wages paid or incurred on or after the LARZ expiration date. The expiration date is the date the LARZ designation expires, is repealed, or becomes inoperative.

17312 Downsizing of the LARZ

For taxpayers eliminated from the LARZ geographic area due to the downsizing of the LARZ, the hiring credit can continue to be incurred for qualified employees hired before 1/1/96 (determination date for the downsizing of the LARZ), assuming all other qualifying tests are met, as if the taxpayer still operated within the LARZ geographic area.

17313 Estates and Trust

In the case of an estate or trust, the qualified wages are apportioned between the estate/trust and the beneficiaries on the basis of the income allocable to each. Consequently, any beneficiary, to whom wages are apportioned, is treated as the employer with respect to those wages.

17320 Qualified Employee - General Hiring Credit

References (Repealed Sections) 17053.17(b)(3); 23623.5(b)(3)

For purposes of the *General Hiring Credit*, a qualified employee is an individual who satisfies all of the following:

ANNUAL TESTS

- The employee is a resident of the LARZ;
- At least 90% of the employee's work for the taxpayer, during the taxable or income year, must be directly related to the conduct of the taxpayer's trade or business located within the LARZ;
- At least 50 percent of the employee's services for the taxpayer, during the taxable or income year, must be performed within the boundaries of the LARZ

NOTE: If a qualified employee moves out of the LARZ, that employee ceases to be a qualified employee.

TIME OF HIRE TESTS

- The employee is hired on or after May 1, 1992.

17321 Leased Employees

The "employer" is the qualified taxpayer and may qualify for the hiring credit for leased employees. The employer can be either the leasing company or the subscriber to the leasing company. Generally, the employer can be identified due to the legal obligation to pay the payroll taxes of the employee, and as to who has the right to control and direct the workers (employee's) services.

Internal Revenue Service (IRS) Publication 15-A, *Employer's Supplemental Tax Guide* provides guidelines for establishing an employment relationship and provides examples to consider in determining the employer-employee relationship

17322 Relocation Into the LARZ

If a business moves into the LARZ, the employer may claim the hiring credit for qualified wages paid to qualified employees. Such individuals must have been hired on or after May 1, 1992, maintained their residence in the LARZ on the date they were hired, continued to be LARZ residents when the employer commenced business in the LARZ, and performed services for the employer in the LARZ as required by statute. In regard to the 90% and 50% tests related to employee activity, the first day of the income or taxable year of relocation is used to determine if these percentages are met. Relocation to the LARZ does not affect the percentage ranges of the hiring credit. The percentage ranges relevant to qualified wages begin with the employee's date of hire, not the date the employer commenced business in the LARZ.

17330 Credit Computation -General Hiring Credit

References (Repealed Sections) 17053.17(a); 23623.5(a)

For each income or taxable year beginning on or after January 1, 1992, and before January 1, 1998, a hiring credit is allowed to a qualified taxpayer for hiring a qualified disadvantaged individual (employee) on or after May 1, 1992 for employment within the LARZ. The credit is equal to the sum of each of the following:

- 50% of the qualified wages during the first year of employment.
- 40% of the qualified wages during the second year of employment.
- 30% of the qualified wages during the third year of employment.
- 20% of the qualified wages during the fourth year of employment.
- 10% of the qualified wages during the fifth year of employment.

The credit percentage is based on the employee's date of employment and subsequent anniversary dates. The taxpayer's tax year does not control the applicable credit percentages. With the exception of the first and last year of the credit, within one tax year, two percentage ranges for the computation of the credit may apply.

> ***Example***: An employee was hired 7/1/1996, and the taxpayer is completing the tax return for the year ending 12/31/1997. For the period 1/1/1997 to 6/30/1997, the hiring credit is based on 50% of qualified wages. For the period 7/1/1997 to 12/31/1997, the hiring credit is based on 40% of qualified wages.

Once the employee commences employment, the credit percentage range begins and generally is not interrupted in the event of a subsequent layoff and rehire of the employee.

> ***Example***: An employee is hired 7/1/1996, is temporarily laid off 2/1/1997, and is rehired 4/1/1997. The 50% credit range runs from 7/1/1996 to 6/30/1997 regardless of the layoff period between 2/1/1997 and 3/31/1997.

17340 Reduction for Other Tax Credits – General Hiring Credit

References (Repealed Sections) 17053.17(e); 23623.5(e)

The LARZ *General Hiring Credit* is reduced by the credits allowable under the following California Revenue & Taxation Code Sections:

- 17053.7 & 23621 (Jobs Tax Credit);
- 17053.10 & 23625 – Repealed (LARZ Construction Hiring Credit);
- 17053.74 & 23622.7 (Enterprise Zone Hiring Credit);
- 23623 – Repealed (Program Areas Hiring Credit); and
- The federal credit allowed under IRC § 51 (Work Opportunity Tax Credit – WOTC).

17350 Wage Expense Deduction

References (Repealed Sections) 17053.10(e); 17053.17(e); 23623.5(e); 23625(e)

The taxpayer must reduce any deduction for wages by the amount of the LARZ hiring credit allowed (including any current year credit to be carried forward).

17360 Credit Will Not Reduce Certain Taxes

The LARZ hiring credits cannot reduce the following:

- Minimum franchise tax (corporations, limited partnerships, limited liability partnerships, LLCs, and S corporations);
- Built-in gains tax (S corporations);
- Excess net passive income tax (S corporation); or
- Alternative minimum tax (corporations, exempt organizations, individuals and fiduciaries).

For taxable or income years beginning on or after January 1, 1993, the LARZ *Construction Hiring Credit* may reduce the regular tax below the tentative minimum tax.

For taxable or income years beginning on or after January 1, 1994, the LARZ General Hiring Credit may reduce the regular tax below the tentative minimum tax.

17370 Credit Usage & Carryover

The aggregate amount of the LARZ hiring credits and the sales or use tax credit, including any credit carryover from prior years, that may reduce the "net tax"/"tax" for the income or taxable year, shall not exceed the amount of tax imposed on the taxpayer's business income attributable to the LARZ, determined as if that income represented all of the income of the taxpayer.

The portion of the LARZ credits that exceed the "net tax"/"tax" for the income or taxable year, are carried over and added to the credit, if any, in the following year. The credit may be carried over to succeeding years, until it is exhausted, or for 15 years from the year the credit was generated, whichever occurs first.

Example: A taxpayer has a $1,500 LARZ *Sales or Use Tax Credit*, a $2,400 LARZ *General Hiring Credit* and a $1,200 LARZ *Construction Hiring Credit*. Tax imposed on LARZ income is $4,700 and the taxpayer's overall "net tax"/"tax" is $4,000. The taxpayer would be eligible to claim $4,000 maximum in LARZ credits.

Sales or Use Tax Credit	$ 1,500
General Hiring Credit	2,400
Construction Hiring Credit	1,200
Total LARZ credit	$5,100
Tax on LARZ income	$4,700
First limitation:	
Lesser of total credit or tax on LARZ income	$4,700
Second limitation:	
Lesser of tax on LARZ Income or "*net tax*"/"*tax*"	$4,000
Maximum credit allowed:	
Lesser of *LARZ tax limitation* or "*net tax*"/"*tax*" *limitation*	$4,000
Total LARZ credit	$5,100
Maximum credit allowed	$4,000
Carryover	$1,100

The LARZ expired on December 1, 1998. If the taxpayer has any unused credits as of this date, the unused credits may continue to be carried forward until they are exhausted, or for 15 years from the year the credit was generated, whichever occurs first. The LARZ is deemed to remain in existence for purpose of computing the business income limitation.

17380 Credit Recapture

References (Repealed Sections) 17053.10(h)(1); 17053.17(c)(1); 17053.17(c)(3); 23623.5(c)(1); 23623.5(c)(3); 25625(h)(1)

Recapture of the hiring credit is required if the employee is terminated at any time during the longer of the following two periods:

- The first 270 days of employment (whether or not consecutive); or
- Ninety (90) days of employment plus 270 calendar days,

A ‘‘day of employment’’ includes any day the employee was paid to work, regardless of whether the employee actually worked (including paid holidays, sick days, and vacation days).

To recapture the credit, the taxpayer must add to the current year's tax the amount of credit claimed for the year of termination, as well as all prior year credit claimed for the terminated employee.

Any increase in tax, due to a credit recapture, is not offset by the current year hiring credit.

17381 Credit Recapture – Exceptions

References (Repealed Sections) 17053.10(h)(2)(A); 17053.17(c)(2)(A); 23623.5(c)(2)(A); 23625(h)(2)(A)

The credit recapture will not apply if the termination was:

- Voluntary on the part of the employee;
- Caused by the employee becoming disabled;
- Due to employee misconduct;
- Due to a substantial reduction in business;
- In order to enable other qualified employees to be hired, creating an increase in the number of qualified employees and the hours of employment; or
- For purposes of the Construction Hiring Credit, due to a contractual agreement.

17400 Construction Hiring Credit

17410 Qualified Wages

References (Repealed Sections) 17053.10(b)(1)-(2); 23625(b)(1)-(2)

Qualified wages, for purposes of the LARZ *Construction Hiring Credit*, means that portion of wages paid or incurred, by the taxpayer to its qualified employees for **construction work** in the LARZ during the income or taxable year.

Qualified wages means that portion of hourly wages that does not exceed 150% of the minimum wage.

- Minimum wage means the wage established by the Industrial Welfare Commission. When the California minimum wage is higher than federal minimum wage, use the California minimum wage for purposes of this credit.
- To determine a salaried employee's hourly wage, divide the total salary by the average hours worked, normally 2,000 hours per year.

17411 Non-Qualified Wages

Qualified wages *do not* include any wages incurred after December 31, 1997.

17412 Downsizing of the LARZ

For taxpayers eliminated from the LARZ geographic area due to the downsizing of the LARZ, the hiring credit can continue to be incurred for qualified employees hired before 1/1/96 (determination date for the downsizing of the LARZ), assuming all other qualifying tests are met, as if the taxpayer still operated within the LARZ geographic area.

17413 Estates and Trust

In the case of an estate or trust, the qualified wages are apportioned between the estate/trust and the beneficiaries on the basis of the income allocable to each. Consequently, any beneficiary, to whom wages are apportioned, is treated as the employer with respect to those wages.

17420 Qualified Employee-Construction Hiring Credit

References (Repealed Sections) 17053.10(b)(3); 23625(b)(3)

For purposes of the *Construction Hiring Credit*, a qualified employee is an individual who satisfies all of the following:

ANNUAL TESTS

- The employee is a resident of the LARZ;
- The employee was hired to perform construction work within the LARZ.

TIME OF HIRE TESTS

- The employee is hired on or after May 1, 1992.

17421 Leased Employees

The "employer" is the qualified taxpayer and may qualify for the hiring credit for leased employees. The employer can be either the leasing company or the subscriber to the leasing company. Generally, the employer can be identified due to the legal obligation to pay the payroll taxes of the employee, and as to who has the right to control and direct the workers (employee's) services.

Internal Revenue Service (IRS) Publication 15-A, Employer's Supplemental Tax Guide provides guidelines for establishing an employment relationship and provides examples to consider in determining the employer-employee relationship

17422 Relocation Into the LARZ

If a business moves into the LARZ, the employer may claim the hiring credit for qualified wages paid to qualified employees. Such individuals must have been hired on or after May 1, 1992, maintained their residence in the LARZ on the date they were hired, continued to be LARZ residents when the employer commenced business in the LARZ, and performed services for the employer in the LARZ as required by statute. In regard to the 90% and 50% tests related to employee activity, the first day of the income or taxable year of relocation is used to determine if these percentages are met. Relocation to the LARZ does not affect the percentage ranges of the hiring credit. The percentage ranges relevant to qualified wages begin with the employee's date of hire, not the date the employer commenced business in the LARZ.

17430 Credit Computation-Construction Hiring Credit

References (Repealed Sections) 17053.10(a); 23625(a)

For each income or taxable year beginning on or after January 1, 1992, and before January 1, 1998, a hiring credit is allowed to a qualified taxpayer for hiring a qualified employee on or after May 1, 1992 for employment within the LARZ. The credit is equal to the sum of each of the following:

- 100% of the qualified wages paid or incurred during the period from May 1, 1992, to the end of the 6th full month (June 30, 1993) *after* the designation of the LARZ, <u>for employees that are hired during this period</u>.
- 75% of the qualified wages paid or incurred during the period from the beginning of the 7th month (July 1, 1993) *after* designation to the end of the 12th full month (December 31, 1993) *after* designation, <u>for employees that are hired during this period</u>.
- 50% of the qualified wages paid or incurred during the period from the beginning of the 13th month (January 1, 1994) *after* designation to the end of the 60th full month (December 31, 1997) *after* designation<u>, for employees that are hired during this period</u>.

NOTE: The LARZ was designated December 31, 1992, operative May 1, 1992.

Example: On December 1, 1993, a business hired a qualified employee to perform construction work in the LARZ. The qualified employee worked in the LARZ from December 1, 1993 through June 30, 1994. The qualified employee's hourly wage was $15.97. The employee was paid for 100 hours during 1993 and 1,000 hours during 1994. The LARZ construction hiring credit for this employee would be computed for 1993 as follows:

75%[$6.37 (150% of minimum wage - not $15.97) x 100]	= $478

<u>*Important*</u>: The business would not be able to claim the LARZ construction hiring credit on qualified wages paid to this employee after December 31, 1993 because the designated period within which this employee was hired expired on December 31, 1993. However, such wages may qualify for the LARZ general hiring credit.

17440 Reduction for Other Tax Credits – Construction Hiring Credit

References (Repealed Sections) 17053.10(d); 23625(d)

The LARZ *Construction Hiring Credit* is reduced by the credits allowable under the following California Revenue & Taxation Code Sections:

- 17053.7 & 23621 (Jobs Tax Credit);
- 17053.8 & 23622 - Repealed (Enterprise Zone Hiring Credit);
- 17053.11 & 23623 - Repealed (Program Areas Hiring Credit);
- 17053.17 & 23623.5 - Repealed (LARZ General Hiring Credit); and
- The federal credit allowed under IRC § 51 (Work Opportunity Tax Credit - WOTC).

17450 Wage Expense Deduction

References (Repealed Sections) 17053.10(e); 17053.17(e); 23623.5(e); 23625(e)

The taxpayer must reduce any deduction for wages by the amount of the LARZ hiring credit allowed (including any current year credit carried forward).

17460 Credit Will Not Reduce Certain Taxes

The LARZ hiring credits cannot reduce the following:

- Minimum franchise tax (corporations, limited partnerships, limited liability partnerships, LLCs, and S corporations);
- Built-in gains tax (S corporations);
- Excess net passive income tax (S corporation); or
- Alternative minimum tax (corporations, exempt organizations, individuals and fiduciaries).

For taxable or income years beginning on or after January 1, 1993, the LARZ *Construction Hiring Credit* may reduce the regular tax below the tentative minimum tax.

For taxable or income years beginning on or after January 1, 1994, the LARZ General Hiring Credit may reduce the regular tax below the tentative minimum tax.

17470 Credit Usage & Carryover

The aggregate amount of the LARZ hiring credits and the sales or use tax credit, including any credit carryover from prior years, that may reduce the "net tax"/"tax" for the income or taxable year, shall not exceed the amount of tax imposed on the taxpayer's business income attributable to the LARZ, determined as if that income represented all of the income of the taxpayer.

The portion of the LARZ credits that exceed the "net tax"/"tax" for the income or taxable year, may be carried over and added to the credit, if any, in the following year. The credit may be carried over to succeeding years, until it is exhausted, or for 15 years from the year the credit was generated, whichever occurs first.

Example: A taxpayer has a $1,500 LARZ *Sales or Use Tax Credit*, a $2,400 LARZ *General Hiring Credit* and a $1,200 LARZ *Construction Hiring Credit*. Tax imposed on LARZ income is $4,700 and the taxpayer's overall "net tax"/"tax" is $4,000. The taxpayer would be eligible to claim $4,000 maximum in LARZ credits.

Sales or Use Tax Credit	$ 1,500
General Hiring Credit	2,400
Construction Hiring Credit	1,200
Total LARZ credit	$5,100
Tax on LARZ income	$4,700
First limitation:	
Lesser of total credit or tax on LARZ income	$4,700
Second limitation:	
Lesser of tax on LARZ Income or "*net tax*"/"*tax*"	$4,000
Maximum credit allowed:	
Lesser of *LARZ tax limitation* or "*net tax*"/"*tax*" *limitation*	$4,000
Total LARZ credit	$5,100
Maximum credit allowed	$4,000
Carryover	$1,100

The LARZ expired on December 1, 1998. If the taxpayer has any unused credits as of this date, the unused credits may continue to be carried forward until they are exhausted, or for 15 years from the year the credit was generated, whichever occurs first. The LARZ is deemed to remain in existence for purpose of computing the business income limitation.

17480 Credit Recapture

References (Repealed Sections) 17053.10(h)(1); 17053.17(c)(1); 17053.17(c)(3); 23623.5(c)(1); 23623.5(c)(3); 25625(h)(1)

Recapture of the hiring credit is required if the employee is terminated at any time during the longer of the following two periods:

- The first 270 days of employment (whether or not consecutive); or
- Ninety (90) days of employment plus 270 calendar days,

A ‘‘day of employment’’ includes any day the employee was paid to work, regardless of whether the employee actually worked (including paid holidays, sick days, and vacation days).

To recapture the credit, the taxpayer must add to the current year's tax the amount of credit claimed for the year of termination, as well as all prior year credit claimed for the terminated employee.

Any increase in tax, due to a credit recapture, is not offset by the current year hiring credit.

17481 Credit Recapture – Exceptions

References (Repealed Sections) 17053.10(h)(2)(A); 17053.17(c)(2)(A); 23623.5(c)(2)(A); 23625(h)(2)(A)

The credit recapture will not apply if the termination was:

- Voluntary on the part of the employee;
- Caused by the employee becoming disabled;
- Due to employee misconduct;
- Due to a substantial reduction in business;
- In order to enable other qualified employees to be hired, creating an increase in the number of qualified employees and the hours of employment; or
- For purposes of the Construction Hiring Credit, due to a contractual agreement.

17500 Minimum Wage Chart

EFFECTIVE DATE	MINIMUM WAGE	MAXIMUM HOURLY WAGE – (150% of Minimum Wage)
July 1, 1988 to September 30, 1996	$4.25	$6.37
October 1, 1996 to February 28, 1997	$4.75	$7.12
March 1, 1997 to August 31, 1997	$5.00	$7.50
September 1, 1997 to February 28, 1998	$5.15	$7.72

17600 Business Income Activity Limitation

References (Repealed Sections) 17053.10(g)(1)-(2); 17053.17(g)(1)-(2); 23623.5(g)(1)-(2); 23625(g)(1)-(2)

The amount of hiring credit or sales or use tax credit (see EDAM 18000) claimed, including any credit carryover from prior years, may not exceed the amount of tax on the LARZ business income in any year. Depending on the tax year involved, the LARZ business income is that portion of the taxpayer's *California source* business income or the worldwide income that is apportioned to the LARZ. Non-business income or loss is not included in the calculation of business income from the LARZ.

Example*:* Corp. A operates entirely within the LARZ. In order to determine the amount of hiring credit allowable, the business income, and the tax on that business income, must be determined. Corp. A has the following items of income and expense:

Income from business operations	$30,000
Interest from investment which is unrelated to Corp. A's business operations	$2,000
Business expenses	(17,000)
Net Taxable Income	$15,000

Corp. A's income attributed to business operations is:

Income from business operations	$30,000
Business expenses	(17,000)
Net Business Income	$13,000

To determine the LARZ hiring credit allowable, the net business income is multiplied by the applicable tax rate.

Net Business Income	$13,000
x 8.84%	x 0.0884
Tax associated with business income	$1,149

In this example, the taxpayer can offset the tax of $1,149 with the hiring credit available (up to $1,149).

NOTE: "net tax"/"tax" and alternative minimum tax impose limitations on the allowable offset but were not considered a factor in this example.

17700 General Provisions – Apportionment of Business Income

References (Repealed Sections) 17053.10(g); 17053.17(g); 23623.5(g); 23625(g)

EDAM 17710 Property Factor – Income Apportionment
EDAM 17720 Payroll Factor – Income Apportionment
EDAM 17730 Apportionment – Combined Groups
EDAM 17740 Apportioning for Personal Income Tax Taxpayers

If a business is located within and outside of the LARZ, the taxpayer must determine the portion of the total business income that is attributable to the LARZ.

- Business income is defined under the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA).
- Components of the factors are defined under the provisions of UDITPA.

For income or taxable years beginning on or after January 1, 1992, and before January 1, 1994, business income is apportioned to the LARZ by multiplying the *worldwide* business income by a fraction, the numerator of which is the property factor plus the payroll factor, and the denominator of which is two (2).

For income or taxable years beginning on or after January 1, 1994, business income is apportioned to the LARZ by multiplying the taxpayer's *California* source business income by a fraction, the numerator of which is the property factor plus the payroll factor, and the denominator of which is two (2).

17710 Property Factor – Income Apportionment

The property factor is a fraction. The numerator of the property factor is the average value of the real and tangible personal property owned or rented and used or available for use by the taxpayer *within the LARZ* during the income or taxable year.

- For income or taxable years beginning on or after January 1, 1992, and before January 1, 1994, the denominator is the average value of all real and tangible personal property owned or rented and used or available for use during the income or taxable year *worldwide.*
- For income or taxable years beginning on or after January 1, 1994, the denominator is the average value of all real and tangible personal property owned or rented and used or available for use by the taxpayer during the income or taxable year *within California*.

Rented property is valued at 8 times the net annual rental rate. The net annual rental rate is the total rent paid for the property, less any subrental rates paid by subtenants.

17720 Payroll Factor – Income Apportionment

The payroll factor is a fraction. The numerator of the payroll factor is the total compensation paid to employees working for the taxpayer *within the LARZ* during the income or taxable year.

- For income or taxable years beginning on or after January 1, 1992, and before January 1, 1994, the denominator is the total compensation paid to employees working *worldwide* during the income or taxable year.
- For income or taxable years beginning on or after January 1, 1994, the denominator is the total compensation paid to employees working for the taxpayer *in California* during the income or taxable year.

Example: For the income year ending 12/31/96, Corp A operates within and outside the LARZ. California business income of $13,000 needs to be apportioned to the LARZ. The following amounts apply to Corp. A's property and payroll:

LARZ Property	$40,000
CA Property	$100,000
LARZ Payroll	$5,000
CA Payroll	$10,000

LARZ Property/CA Property	=.40	
LARZ Payroll/CA Payroll	=.50	
	.90/2 = .45	LARZ Apportionment Factor

Business income	$13,000
Apportionment Factor	x 0.45
LARZ Business Income	$5,850
Applicable Tax Rate	x .0884
Tax attributable to LARZ business income	$517

NOTE: Had the above example been for an income or taxable year beginning on or after January 1, 1992, and before January 1, 1994, the denominator of the property and payroll factors would have been from worldwide sources rather than CA sources. See EDAM 23440.

17730 Apportionment – Combined Groups

For income or taxable years beginning on or after January 1, 1992, and before January 1, 1994: For members of a combined group, the credit limitation will be based on combined groups worldwide business income (before CA apportionment). The numerator of the apportionment formula will be based on each LARZ taxpayer's separate LARZ payroll and property amounts, and the denominator will be based on the combined groups worldwide payroll and property amounts.

For an example of apportionment under this method refer to EDAM 23440.

For income or taxable years beginning on or after 1/1/1994: For members of a combined group, the limitation will be based on the intrastate apportioned business income for each taxpayer doing business within the LARZ. The numerator of the apportionment formula will be based on each LARZ taxpayer's separate LARZ property and payroll amounts and the denominator will be based on each LARZ taxpayer's separate California property and payroll amounts.

Example: For the income year ending 12/31/997, parent corporation A has two subsidiaries, B and C. Corporations A and B operate within the LARZ. The combined group operates within and outside California and apportions its income to California using Schedule R. The combined group's business income apportioned to California was $1,000,000. Corporation A and B's share of California business income is $228,000 and $250,000 respectively. Corporation A and B's separate LARZ and separate California property and payroll factor amounts are shown below.

Business income apportioned to the LARZ was determined as follows:

	A	**B**
<u>Property Factor</u>		
LARZ Property	$1,000,000	$ 800,000
California Property	$1,000,000	$1,200,000
Apportionment %	100%	66.66%
<u>Payroll Factor</u>		
LARZ Payroll	$800,000	$ 800,000
California Payroll	$800,000	$1,000,000
Apportionment %	100%	80%
Average Apport. % (Property + Payroll Factors)/2	100%	73.33%

Apportioned Business Income	$228,000	$250,000
LARZ Income	$228,000	$183,333

17740 Apportioning for Personal Income Tax Taxpayers

The following examples show the application of the apportioning rules to personal income tax taxpayers.

Example: Ray Smith is vice president of an S corporation that has two locations, one within the LARZ and one outside the LARZ. Eighty percent (80%) of the S corporation's business is attributable to the LARZ. (**NOTE**: This percentage was determined by the S corporation, using Worksheet V from the FTB 3806 Business Booklet, at the time the S corporation return was prepared). Ray divides his time equally (50% & 50%) between the two offices of the S corporation.

Mary Smith (Ray's spouse) works for the S corporation at its office located within the LARZ.

Ray and Mary Smith have the following 1997 items of California income and expense:

Ray's salary from the S corp.	$100,000
Mary's salary from the S corp.	75,000
Interest on savings account	1,000
Dividends	3,000
Schedule K-1(100S) from the S corp.	
Ordinary income	40,000
LARZ business expense deduction	(5,000)*
Ray's unreimbursed employee expenses from Schedule A	(2,000)

*The LARZ business expense deduction is a separately stated item on Schedule K-1 (100S).

The Smith's LARZ income is computed as follows:

Ray's LARZ salary ($100,000 x 50%)	$50,000
Mary's LARZ salary ($75,000 x 100%)	75,000
Pass-through ordinary income from the S-Corp. ($40,000 x 80%)	32,000
LARZ business expense deduction from the S-Corp.	(5,000)
Ray's unreimbursed employee business expenses (2,000 x 50%)	(1,000)
Total LARZ income	**$151,000**

Ray and Mary must compute the tax on the total LARZ income of $151,000 (as if it represents all of their income). Using the tax rate schedule for the filing status *married filing joint*; the tax on $151,000 is $10,659. The $10,659 is the first limitation on LARZ credits for the tax year. The second limitation on the credits is the *net tax* on all income.

NOTE: The standard deduction and personal or dependency exemptions are not included in the computation of LARZ income since they are not related to trade or business activities.

17800 Record Keeping

For each qualified employee, documentation should be kept showing the following:

- Employee name
- Date employee was hired
- Number of hours the employee worked for each month of employment
- Wage rate paid for each month of employment
- Schedule calculating the hiring credit
- Overtime hours
- Location where services were performed
- Date employee was terminated, and reason why

Section 18000 LOS ANGELES REVITALIZATION ZONE SALES OR USE TAX CREDIT

References (Repealed Sections) 17052.15(a); 17052.15(d); 23612.6(a); 23612.6(d)

For each income or taxable year beginning on or after January 1, 1992 and before January 1, 1998, a taxpayer engaged in a trade or business within the Los Angeles Revitalization Zone (LARZ) can take a credit for sales or use tax paid or incurred in connection with the purchase of qualified property.

The LARZ was established to aid economic development in areas that suffered damage during the civil unrest that occurred in the County of Los Angeles during April and May 1992. The LARZ became operative on May 1, 1992, and applied to businesses with taxable or income years beginning on or after January 1, 1992. The LARZ expired on December 1, 1998.

- No new LARZ credits may be generated in taxable or income years beginning on or after January 1, 1998. However, LARZ credit carryovers may still be claimed for 15 years from the year the credit was generated.

- Taxpayers that receive a LARZ *Sales or Use Tax Credit* in their taxable or income year beginning on or after January 1, 1998, from a 1997 fiscal year pass-through entity *may not* claim this credit in their taxable or income year beginning on or after January 1, 1998. This credit can only be claimed for taxable or income years beginning *before* January 1, 1998.

18100 Geographic Boundaries

For a listing of LARZ cities, see "LARZ *Locations and Designation Dates*" EDAM 1350. To verify an address, refer to EDAM 1300.

NOTE: Effective 1/1/96, the LARZ geographic area was re-determined (downsized) to eliminate previously qualified addresses. For taxpayers that operate in the portion of the LARZ that was excluded when the LARZ was downsized, LARZ benefits that were incurred when the LARZ designation was effective are allowed after downsizing (carryover amounts). In regards to the applicability of LARZ benefits incurred after the downsize of the LARZ, the sales or use tax credit is no longer available, as of the first day of the income or taxable year beginning on or after January 1, 1996, the determination date.

18200 Exclusive Credit

References (Repealed Sections) 17052.15(c); 23612.6(c)

If the LARZ sales or use tax credit is claimed for the purchase of qualified property during the income or taxable year, no other credit is allowed with respect to that property.

18300 Qualified Taxpayer

References (Repealed Sections) 17052.15(b)(1); 23612.6(b)(1)

EDAM 18310 Pass-Through Entities

A "taxpayer" is a person or entity engaged in a trade or business within the LARZ.

18310 Pass-Through Entities

The determination of whether a taxpayer is a qualified taxpayer is made at the entity level. The term "pass-through entity" means any partnership or S corporation. The sales or use tax credit is allowed to the pass-through entity and passed through to the partners or shareholders.

18400 Qualified Property

References (Repealed Sections) 17052.15(b)(2); 23612.6(b)(2)

EDAM 18410 Capitalized Requirement
EDAM 18420 Leased Property

Qualified property is property purchased on or after May 1, 1992, and before the zone expiration date. Qualified property is the purchase of either, or both, of the following:

- Building materials to replace or repair the taxpayer's building and fixtures;
- Machinery or equipment, excluding inventory, to be used by the taxpayer exclusively in the LARZ.

18410 Capitalized Requirement

References (Repealed Sections) 17052.15(b)(2); 23612.6(b)(2)

Qualified property must be purchased and placed in service before the LARZ expires, is no longer binding or becomes inoperative. Qualified property cost(s) are costs chargeable to a capital account (subject to depreciation) of the qualified taxpayer. If costs are expensed, rather than capitalized, no credit is allowed.

18420 Leased Property

Taxpayers who acquire property by lease arrangement may qualify for the sales or use tax credit. Lease arrangements structured using a financial (conditional sales) contract generally will qualify the taxpayer to take the sales or use tax credit. For reference sources to determine if a lease qualifies as a purchase rather than a lease arrangement, refer to IRS Revenue Ruling 55-540, 1955-2 C.B. 39, and FTB Legal Ruling 94-2, March 23, 1994.

18500 Credit Computation

References (Repealed Sections) 17052.15(a); 23612.6(a)

EDAM 18510	Depreciation
EDAM 18520	Business Income Activity Limitation
EDAM 18530	General Provisions – Income Apportionment
EDAM 18531	Property Factor – Income Apportionment
EDAM 18532	Payroll Factor – Income Apportionment
EDAM 18533	Apportionment – Combined Groups
EDAM 18534	Apportioning for Personal Income Tax Taxpayers
EDAM 18540	S Corporation & Shareholder Credit Amounts

The sales or use tax credit is equal to the amount of sales or use tax “paid or incurred” by the taxpayer in connection with the purchase and use of qualified property. Qualified property costs are not limited for LARZ entities.

Example: Taxpayer spent $53,750 to purchase machinery used in the taxpayer's business within the LARZ. The sales tax paid on the purchase is $3,750. The sales tax credit is $3,750.

NOTE: Upon acquisition, if the taxpayer/purchaser was exempt from paying sales tax on the property under the California Revenue & Taxation Code (CR&TC), then the taxpayer/purchaser did not pay or incur sales tax in connection with the purchase of the property to the extent of the exemption. Thus, the taxpayer/purchaser is not allowed to take the sales or use tax credit on the amount of the exemption.

18510 Depreciation

References 18036; 24916;(Repealed Sections) 17052.15(e); 23612.6(e)

Taxpayers electing to utilize the sales or use tax credit are not entitled to increase the basis of the property for which sales or use tax was paid or incurred in connection with the purchase of the property.

Example: Taxpayer spent $53,750 to purchase machinery used in the taxpayer's business within the LARZ. The sales tax included in the purchase price was $3,750. The depreciable basis of the property is $50,000 ($53,750 less $3,750 sales tax).

Depreciation of the capitalized cost of the asset may be claimed using any method of depreciation allowable beginning in the year the asset is placed in service.

NOTE: If the business expense deduction is taken for the same property, relevant depreciation will start with the income or taxable year following the year in which the property is placed in service. The depreciation is calculated on the remaining basis *after* reduction for the sales or use tax credit and business expense deduction amounts.

18520 Business Income Activity Limitation

References (Repealed Sections) 17052.15(f)(1)-(2); 23612.6(f)(1)-(2)

The amount of sales or use tax credit or hiring credit (see EDAM 17000) claimed, including any credit carryover from prior years, may not exceed the amount of tax on the LARZ business income in any year. Depending on the tax year involved, the LARZ business income is that portion of the taxpayer's *California source* business income or the worldwide income that is apportioned to the LARZ. Non-business income or loss is not included in the calculation of business income from the LARZ.

Example: Corp. A operates exclusively within the LARZ. In order to determine the amount of sales or use tax credit allowable, the business income and the tax on that business income must be determined. Corp. A has the following items of income and expense:

Income from business operations	$30,000
Interest from investment which is unrelated to Corp. A's business operations	$2,000
Business expenses	(17,000)
Net Taxable Income	$15,000

Corp. A's income attributed to business operations is:

Income from business operations	$30,000
Business expenses	(17,000)
Net Business Income	$13,000

To determine the sales or use tax credit allowable, the net business income is multiplied by the applicable tax rate.

Net Business Income	$13,000
x 8.84%	x 0.0884
Tax associated with business income	$1,149

In this example, the taxpayer can offset the tax of $1,149 with the sales or use tax credit available (up to $1,149).

NOTE: "net tax"/"tax" and alternative minimum tax impose limitations on the allowable offset but were not considered a factor in this example.

18530 General Provisions – Income Apportionment

References (Repealed Sections) 17052.15(f)(1)-(2); 23612.6(f)(1)-(2)

If a business is located within and outside of the LARZ, the taxpayer must determine the portion of the total business income that is attributable to the LARZ.

- Business income is defined under the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA).
- Components of the factors are defined under the provisions of UDITPA.

For income or taxable years beginning on or after January 1, 1992, and before January 1, 1994, business income is apportioned to the LARZ by multiplying the *worldwide* business income by a fraction, the numerator of which is the property factor plus the payroll factor, and the denominator of which is two (2).

For income or taxable years beginning on or after January 1, 1994, business income shall be apportioned to the LARZ by multiplying the taxpayer's *California* source business income by a fraction, the numerator of which is the property factor plus the payroll factor, and the denominator of which is two (2).

18531 Property Factor – Income Apportionment

The property factor is a fraction. The numerator of the property factor is the average value of the real and tangible personal property owned or rented and used or available for use by the taxpayer *within the LARZ* during the income or taxable year.

- For income or taxable years beginning on or after January 1, 1992, and before January 1, 1994, the denominator is the average value of all real and tangible personal property owned or rented and used or available for use during the income or taxable year *worldwide.*
- For income or taxable years beginning on or after January 1, 1994, the denominator is the average value of all real and tangible personal property owned or rented and used or available for use by the taxpayer during the income or taxable year *within California*.

Rented property is valued at 8 times the net annual rental rate. The net annual rental rate is the total rent paid for the property, less any subrental rates paid by subtenants.

18532 Payroll Factor – Income Apportionment

The payroll factor is a fraction. The numerator of the payroll factor is the total compensation paid to employees working for the taxpayer *within the LARZ* during the income or taxable year.

- For income or taxable years beginning on or after January 1, 1992, and before January 1, 1994, the denominator is the total compensation paid to employees working *worldwide* during the income or taxable year.
- For income or taxable years beginning on or after January 1, 1994, the denominator is the total compensation paid to employees working for the taxpayer *in California* during the income or taxable year.

Example: For the income year ending 12/31/96, Corp A operates within and outside the LARZ. California business income of $13,000 needs to be apportioned to the LARZ. The following amounts apply to Corp. A's property and payroll:

LARZ Property	$40,000
CA Property	$100,000
LARZ Payroll	$5,000
CA Payroll	$10,000

LARZ Property/CA Property	=.40	
LARZ Payroll/CA Payroll	=<u>.50</u>	
	.90/2 = .45	LARZ Apportionment Factor

Business income	$13,000
Apportionment Factor	<u>x 0.45</u>
LARZ Business Income	$5,850
Applicable Tax Rate	<u>x .0884</u>
Tax attributable to LARZ business income	$517

NOTE: Had the above example been for an income or taxable year beginning on or after January 1, 1992, and before January 1, 1994, the denominator of the property and payroll factors would have been from worldwide sources rather than CA sources. See EDAM 23440.

18533 Apportionment – Combined Groups

For income or taxable years beginning on or after January 1, 1992, and before January 1, 1994: For members of a combined group, the credit limitation will be based on combined groups worldwide business income (before CA apportionment). The numerator of the apportionment formula will be based on each LARZ taxpayer's separate LARZ payroll and property amounts, and the denominator will be based on the combined groups worldwide payroll and property amounts.

For an example of apportionment under this method refer to EDAM 23440.

For income or taxable years beginning on or after 1/1/1994: For members of a combined group, the limitation will be based on the intrastate apportioned business income for each taxpayer doing business within the LARZ. The numerator of the apportionment formula will be based on each LARZ taxpayer's separate LARZ property and payroll amounts and the denominator will be based on each LARZ taxpayer's separate California property and payroll amounts.

Example: For the income year ending 12/31/96, parent corporation A has two subsidiaries, B and C. Corporations A and B operate within the LARZ. The combined group operates within and outside California and apportions its income to California using Schedule R. The combined group's business income apportioned to California was $1,000,000. Corporation A and B's share of California business income is $228,000 and $250,000 respectively. Corporation A and B's separate LARZ and separate California property and payroll factor amounts are shown below.

Business income apportioned to the LARZ was determined as follows:

	A	**B**
Property Factor		
LARZ Property	$1,000,000	$ 800,000
California Property	$1,000,000	$1,200,000
Apportionment %	100%	66.66%
Payroll Factor		
LARZ Payroll	$800,000	$ 800,000
California Payroll	$800,000	$1,000,000
Apportionment %	100%	80%
Average Apport. % (Property + Payroll Factors)/2	100%	73.33%

Apportioned Business Income	$228,000	$250,000
LARZ Income	$228,000	$183,333

18534 Apportioning for Personal Income Tax Taxpayers

The following examples show the application of the apportioning rules to personal income tax taxpayers.

Example: Ray Smith is vice president of an S corporation that has two locations, one within the LARZ and one outside the LARZ. Eighty percent (80%) of the S corporation's business is attributable to the LARZ. (**NOTE**: This percentage was determined by the S corporation, using Worksheet V from the FTB 3806 Business Booklet, at the time the S corporation return was prepared). Ray divides his time equally (50% & 50%) between the two offices of the S corporation.

Mary Smith (Ray's spouse) works for the S corporation at its office located within the LARZ.

Ray and Mary Smith have the following items of California income and expense:

Ray's salary from the S corp.	$100,000
Mary's salary from the S corp.	75,000
Interest on savings account	1,000
Dividends	3,000
Schedule K-1(100S) from the S corp.	
Ordinary income	40,000
LARZ business expense deduction	(5,000)*
Ray's unreimbursed employee expenses from Schedule A	(2,000)

*The LARZ business expense deduction is a separately stated item on Schedule K-1 (100S).

The Smith's LARZ income is computed as follows:

Ray's LARZ salary ($100,000 x 50%)	$50,000
Mary's LARZ salary ($75,000 x 100%)	75,000
Pass-through ordinary income from the S-Corp. ($40,000 x 80%)	32,000
LARZ business expense deduction from the S-Corp.	(5,000)
Ray's unreimbursed employee business expenses (2,000 x 50%)	(1,000)
Total LARZ income	**$151,000**

Ray and Mary must compute the tax on the total LARZ income of $151,000 (as if it represents all of their income). Using the tax rate schedule for the filing status *married filing joint*; the tax on $151,000 is $10,659. The $10,659 is the first limitation on LARZ credits for the tax year. The second limitation on the credits is the *net tax* on all income.

NOTE: The standard deduction and personal or dependency exemptions are not included in the computation of LARZ income since they are not related to trade or business activities.

18540 S Corporation & Shareholder Credit Amounts

References 23803(a)

S corporations operating within the LARZ may claim a credit on the sales or use tax paid or incurred to purchase qualified property during each income or taxable year. An S corporation's sales or use tax credit may reduce the LARZ tax at both the corporate and shareholder levels. However, the S corporation may only use one-third (1/3) of the credit to reduce the tax on the S corporation's LARZ income.

One hundred percent (100%) of the LARZ credits are passed through to the S corporation shareholders. The shareholders claim their pro-rata share of the credit calculated under the California personal income tax law. The Schedules K (100S) and Schedule K-1 (100S) must state the credit amounts allocable to the shareholders.

Example: Corp. Z, an S corporation, purchases $2 million of qualified property, and elects to take the LARZ sales or use tax credit. Corp. Z is allowed to claim a sales or use tax credit of $50,000 ($2,000,000 x 7.5% x 1/3 = $50,000). [Cost x sales tax rate x 1/3 S corporation credit limitation]

The corporation's two shareholders are each allocated a sales or use tax credit of $75,000 based on their pro rata share. (($2,000,000 x 7.5%) / 2 = $75,000). [(Cost x sales tax rate)* pro rata share (percentage)]

18600 Sales or Use Tax Credit and the Hiring Credit

References (Repealed Sections) 17052.15(f)(1); 23612.6(f)(1)

The amount of credit(s) allowed, in any income or taxable year, when a taxpayer is eligible to take both the sales or use tax credit and the hiring credit, is limited to the amount of tax imposed on the LARZ business income. Thus, the taxpayer must aggregate the credits and limit the total amount of credits to tax imposed on the LARZ business income.

18700 Credit Usage and Carryover

References (Repealed Sections) 17052.15(d); 17052.15(f); 23612.6(d); 23612.6(f)

EDAM 18710 Credit Will Not Reduce Certain Taxes

The portion of the credit that exceeds the "net tax"/"tax" for the income or taxable year, may be carried over and added to the credit, if any, in the following year. The credit may be carried over to the succeeding 15 income or taxable years, or until it is exhausted, whichever occurs first.

The aggregate amount of LARZ credits, including any credit carryover from prior years, that may reduce the "net tax"/"tax" for the income or taxable year, shall not exceed the amount of tax imposed on the taxpayer's business income attributable to the LARZ, determined as if that income represented all of the income of the taxpayer.

Example: A taxpayer has $4,900 in LARZ credits (sales or use tax credit *and* hiring credit). Tax imposed on LARZ business income is $4,700 and the taxpayer's overall "net tax"/"tax" is $4,000. The maximum amount of credit is limited to the lesser of the tax on the LARZ business income, or the tax on the taxpayer's overall "net tax"/"tax".

Total LARZ credit	$4,900
Tax on LARZ income	$4,700
First limitation:	
Lesser of total credit or tax on LARZ income	$4,700
Second limitation:	
Lesser of tax on LARZ income or "*net tax*"/"*tax*"	$4,000
Maximum credit allowed:	
Lesser of *LARZ tax limitation* or "*net tax*"/"*tax*" *limitation*	$4,000
Total LARZ credit	$4,900
Maximum credit allowed	$4,000
Carryover	$ 900

The LARZ expired on December 1, 1998. If the taxpayer has any unused credits as of this date, the unused credits may continue to be carried forward until they are exhausted, or for 15 years from the year the credit was generated, whichever occurs first. The LARZ will be deemed to remain in existence for purpose of computing the business income limitation.

18710 Credit Will Not Reduce Certain Taxes

The LARZ sales or use tax credit cannot reduce the:

- Minimum franchise tax (corporations, limited partnerships, limited liability partnerships, LLCs, and S corporations);
- Built-in gains tax (S corporations);
- Excess net passive income tax (S corporation);
- Alternative minimum tax (corporations, exempt organizations, individuals and fiduciaries); or
- Regular tax below tentative minimum tax for income or taxable years beginning prior to January 1, 1993.

The LARZ sales or use tax credit may however reduce regular tax below tentative minimum tax for income and taxable years beginning on or after January 1, 1993.

18800 *Credit Recapture*

References (Repealed Sections) 17052.15(g); 23612.6(g): See also Cal. Code Regs. (CCR) § 17267.2-1(a); 24356.7-1

Recapture of the LARZ sales or use tax credit is required if the qualified property is disposed of or no longer used by the taxpayer in the LARZ at any time before the close of the second income or taxable year after the property is placed in service. The amount of the credit previously claimed for that property is added to the taxpayer's tax liability in the income or taxable year of that disposition or nonuse.

Example: Corp. A purchases property on June 1, 1995, that qualifies Corp A to take the LARZ sales or use tax credit. Corp A's taxable year ends December 31 of each year. Corp A disposes of the property August 5, 1997. The credit is recaptured in the 1997 taxable year as the property was disposed of before the close of the second taxable or income year [12/31/1997] after the property was placed in service. Corp A will increase its basis in the asset by the recaptured amount effective January 1, 1997.

NOTE: The State Board of Equalization in an unpublished and uncitable decision agreed that the statute requires the closure of two taxable years after the end of the taxable year in which the property is placed in service and the election to claim the deduction on the original return is made. *Appeal of Accurate Metal Fabricators, Inc., 32552, Cal. St. Bd. Of Equal., July 3, 2000.*

18900 Record Keeping Requirements

To support the sales or use tax credit claimed, the taxpayer must keep all records that document the purchase of the qualified property. This includes items such as purchase receipts and proof of payment. In addition, taxpayers should keep all records that identify or describe:

- The property purchased (such as serial numbers, etc.);
- The amount of sales or use tax paid or incurred upon purchase; and
- The location where the machinery is used.

Section 19000 LOS ANGELES REVITALIZATION ZONE BUSINESS EXPENSE DEDUCTION

References (Repealed Sections) 17266(a); 24356.4(a)

The Los Angeles Revitalization Zone (LARZ) was established to aid economic development in areas that suffered damage during the civil unrest that occurred in the County of Los Angeles during April and May 1992. The LARZ became operative on May 1, 1992, and applied to businesses with taxable or income years beginning on or after January 1, 1992. The LARZ expired on December 1, 1998.

For income or taxable years beginning on or after January 1, 1992, and prior to January 1, 1998, the law allowed taxpayers, who conducted a trade or business within the LARZ, to elect to treat the cost of qualified property as a business expense rather than a capital item. The deduction was allowed for the income or taxable year in which the property was placed in service.

NOTE: The LARZ business expense deduction may not be generated in taxable or income years beginning on or after January 1, 1998. Taxpayers that receive a LARZ *business expense deduction* in their taxable or income year beginning on or after January 1, 1998, from a 1997 fiscal year pass-through entity *may* claim this deduction in their taxable or income year beginning on or after January 1, 1998.

19100 Geographic Boundaries

For a listing of LARZ cities, see "LARZ *Locations and Designation Dates*" EDAM 1350. To verify an address, refer to EDAM 1300.

NOTE: Effective 1/1/96, the LARZ geographic area was re-determined (downsized) to eliminate previously qualified addresses. For taxpayers that operate in the portion of the LARZ that was excluded when the LARZ was downsized, LARZ benefits that were incurred when the LARZ designation was effective are allowed after downsizing (carryover amounts). In regards to the applicability of LARZ benefits incurred after the downsize of the LARZ, the business expense deduction is no longer available, as of the first day of the income or taxable year beginning on or after January 1, 1996, the determination date.

19200 Qualified Taxpayer

References (Repealed Sections) 17266(c)(1); 24356.4(c)(1)

EDAM 19210	Estates and Trusts
EDAM 19220	Pass-Through Entities

For purposes of the LARZ business expense deduction, *taxpayer* means a person or entity that conducts a trade or business within the LARZ.

19210 Estates and Trusts

References (Repealed Section) 17266(e)

Estates and trusts are not allowed to take the business expense deduction.

19220 Pass-Through Entities

The determination of whether a taxpayer is a qualified taxpayer is made at the entity level. The term "pass-through entity" means any partnership or S corporation. The business expense deduction is allowed to the pass-through entity and passed through to the partners or shareholders.

19300 Qualified Property

References (Repealed Sections) 17266(c); 17266(g); 24356.4(c); 24356.4(e)

EDAM 19310 Leased Property
EDAM 19320 Property Not Qualified

Qualified property is IRC § 1245 property (as defined in section 1245(a)(3) of the Internal Revenue Code) purchased and placed in **service on or after September 1, 1992**, for *exclusive use* in a trade or business conducted within the LARZ. The property must also be purchased and placed in service *before* the date the LARZ designation expires, is repealed, or becomes inoperative.

Qualified property under IRC § 1245 includes, but is not limited to, tangible personal property (excluding buildings and inventory) that is subject to the allowance for depreciation. This includes most equipment and furnishings purchased for exclusive use within the LARZ. Office supplies and other small non-depreciable items are not included.

19310 Leased Property

Taxpayers who acquire property by lease arrangement may be able to take the business expense deduction. The structure of the leasing arrangement itself is critical. Lease arrangements structured using a financial (conditional sales) contract generally will qualify the taxpayer to take the business expense deduction. For reference sources to determine if a lease qualifies as a purchase rather than a lease arrangement, refer to IRS Revenue Ruling 55-540, 1955-2 C.B. 39, and FTB Legal Ruling 94-2, March 23, 1994.

19320 Property Not Qualified

References (Repealed Sections) 17266(c); 17266(d); 17266(f); 24356.4(c); 24356.4(d)

The business expense deduction is not allowed if the property:

- Was transferred between members of an affiliated group;
- Was acquired as a gift or inherited;
- Was traded for other property;
- Was received from a personal or business relation as defined by IRC § 267, as modified by 17266(c)(3)(A) and 24356.4(c)(3)(A);
- Was received from a personal or business relation as defined by IRC § 707(b); or
- Is described in IRC § 168(f).

19400 Deduction Amount

References (Repealed Sections) 17266; 24356.4

EDAM 19410 Basis reduction / Depreciation
EDAM 19420 Interaction with the Manufacturer's Investment Credit
EDAM 19430 Recapture

There are no limitations for the LARZ business expense deduction. The full cost of the qualified property can be expensed. However, the basis of the asset is to be reduced by the expense deduction claimed.

This deduction is available for income or taxable years beginning on or after January 1, 1992 and before January 1, 1998. No deduction is allowed for property purchased after the date the LARZ designation expires, is repealed, or becomes inoperative.

19410 Basis reduction / Depreciation

References (Repealed Sections) 17266(a); 24356.4(a)

Taxpayers electing to take the business expense deduction cannot claim the additional first year depreciation allowed under IRC § 179 / CR&TC § 24356 for the same property.

The basis of the asset is to be reduced by the expense deduction claimed.

19420 Interaction with the Manufacturer's Investment Credit

References 17053.49(b)(1)(C); 23649(b)(1)(C)

Taxpayers claiming the business expense deduction and the Manufacturers' Investment Credit (MIC) for the same property must reduce MIC qualified costs by the amount of the business expense deduction before computing the MIC. Taxpayers that elect to take the business expense deduction are not allowed to capitalize the expensed amount.

19430 Recapture

References (Repealed Sections) 17266(h); 24356.4(f): See also Cal. Code Regs. (CCR) § 17267.2-1(a); 24356.7-1

The business expense deduction is subject to recapture (added back to income) if, before the *close of the second income or taxable year after* the property is placed in service, the property is sold, disposed of, or is no longer used exclusively within the LARZ trade or business.

To recapture the amount deducted, add to the current year income, the amount previously deducted for that property.

Example: Corp A purchases property on June 1, 1995, that qualifies it to take the LARZ business expense deduction. Corp A's taxable year ends December 31 of each year. Corp A disposes of the property August 5, 1997. The previous deduction is added to income in the 1997 taxable year because the property was disposed of before the close of the second taxable year after the property was placed in service (12/31/1997). The basis in the asset is increased by the recaptured amount effective January 1, 1997.

NOTE: The State Board of Equalization in an unpublished and uncitable decision held that the statute requires the closure of two taxable years after the end of the taxable year in which the property is placed in service and the election to claim the deduction on the original return is made. *Appeal of Accurate Metal Fabricators, Inc., 32552, Cal. St. Bd. Of Equal., July 3, 2000.*

19500 Making the Election

References (Repealed Sections) 17266(a); 17266(b); 24356.4(a); 24356.4(b)

The taxpayer must make an election to treat the cost of qualified property as a business expense, on the original return filed for the income or taxable year the property is first placed in service. The election must specify the items to which the election applies and the cost taken into account for purposes of determining the deduction amount.

The election may not be revoked, unless the taxpayer has obtained the consent of the Franchise Tax Board.

NOTE: For the 1992 income or taxable year, a taxpayer could file an amended return to claim the LARZ business expense deduction. The amended return had to be filed no later than June 30, 1994 (see FTB Notice 93-9).

The taxpayer makes the election by using:

- Form FTB 3806 - Los Angeles Revitalization Zone Deduction and Credit Summary.

19600 Creating a Net Operating Loss

Unlike IRC § 179, there is *no* statutory prohibition on the amount of business expense deduction that may create a net operating loss.

19700 Alternative Minimum Tax

References 17062; 23457

The business expense deduction is *not* listed as a tax preference item.

19800 Checklist To Determine Eligibility for the Business Expense Deduction

Checklist Items	Yes	No
Is the business qualified? • Is a trade or business conducted within the LARZ? See EDAM 17200, "*Taxpayer Defined*".		
Is the property qualified? • Qualified property is Section 1245 property. See EDAM 18400, "*Qualified Property"*. • Is the property used exclusively within the boundaries of the LARZ?		
Is the correct deduction amount claimed? • Verify purchase on invoices or receipts. • Verify the date the property is placed in service. • The deduction is only available for income or taxable years beginning on or after January 1, 1992 and before January 1, 1998.		
Was a timely election made? • Election made on original return? • Form FTB 3806 – Los Angeles Revitalization Zone Deduction and Credit Summary, or a separate statement attached to the return?		
Was the property acquired through a valid transaction? • See EDAM 19320, "*Property Not Qualified*".		
Were other deductions claimed for the same property? IRC § 179 expense may not be claimed for qualified property for which the business expense deduction is claimed.		
Is the deduction subject to recapture? • Was the property sold, disposed of or no longer used by the taxpayer in the LARZ, before the close of the second income or taxable year after the property was placed in service? • Check current location of the qualified property. • Check sale or disposal date of qualified property.		

19900 Record Keeping Requirements

To support the business expense deduction claimed, the taxpayer must keep all records that document the purchase of the qualified property. This includes items such as purchase receipts and proof of payment. In addition, taxpayers should keep all records that identify or describe:

- The property purchased (such as serial numbers, etc.); and
- The location where the property is used

Section 20000 LOS ANGELES REVITALIZATION ZONE NET OPERATING LOSS

References 17276.1(a); 24416.1(a); Repealed Sections 17276.4(a)(1); 24416.4(a)

The Los Angeles Revitalization Zone (LARZ) was established to aid economic development in areas that suffered damage during the civil unrest that occurred in the County of Los Angeles during April and May 1992. The LARZ became operative on May 1, 1992, and applied to businesses with taxable or income years beginning on or after January 1, 1992. The LARZ expired on December 1, 1998.

Taxpayers are required to annually report their income and expenses. Due to possible fluctuations in income and expenses, a taxpayer may have substantial profits in one year, while losses in another. In years where expenses exceed income, a net operating loss (NOL) occurs.

For entities conducting business within the LARZ, a qualified taxpayer may elect to carry forward 100% of its NOLs for a 15-year period.

A LARZ NOL cannot be generated until the first taxable or income year beginning on or after the area was officially designated the LARZ.

NOTE: The LARZ NOL may not be generated in taxable or income years beginning on or after January 1, 1998. Taxpayers that report an operating loss attributed to the LARZ from a pass through entity, in their taxable or income year beginning on or after January 1, 1998, from a 1997 fiscal year pass-through entity *may not* claim the LARZ NOL in their taxable or income year beginning on or after January 1, 1998. Each taxpayer must determine and elect the NOL treatment.

Prior to January 1, 1998, the applicable LARZ NOL code sections were:

- 17276 - 17276.1, 17276.2(b), 17276.3
- 24416 - 24416.1, 24416.2(b), 24416.3

For taxable or income years beginning on or after January 1, 1998, the LARZ NOL code sections are:

- 17276 - 17276.1, 17276.3, 17276.4
- 24416 - 24416.1, 24416.3, 24416.4

The following references are to the new code section numbers.

20100 Geographic Boundaries

For a listing of LARZ cities, see "LARZ *Locations and Designation Dates*" EDAM 1350. To verify an address, refer to EDAM 1300.

NOTE: Effective 1/1/96, the LARZ geographic area was re-determined (downsized) to eliminate previously qualified addresses. For taxpayers that operate in the portion of the LARZ that was excluded when the LARZ was downsized, LARZ benefits that were incurred when the LARZ designation was effective are allowed after downsizing (carryover amounts). In regards to the applicability of LARZ benefits incurred after the downsize of the LARZ, the net operating loss is no longer available, as of the first day of the income or taxable year beginning on or after January 1, 1996, the determination date.

20200 Qualified Taxpayer

References (Repealed Sections) 17276.4(a); 24416.4(a)

EDAM 20210	Pass-Through Entities
EDAM 20211	S Corporations

For purposes of the LARZ NOL, a qualified taxpayer includes a person or entity that is engaged in a trade or business within the LARZ.

Taxpayers doing business in an area that was previously not a qualified area, but later designated as qualified, are allowed to utilize the LARZ NOL for the taxable or income year beginning on or after the date the area is designated as part of the LARZ.

20210 Pass-Through Entities

In the case of any "pass-through entity", the determination of whether a taxpayer is a qualified taxpayer is made at the entity level.

20211 S Corporations

References 23802(d)(1)-(2)

For qualified taxpayers electing S corporation status *after* the designation of the LARZ, the qualified NOL attributed to the C corporation years cannot offset S corporation net income.

20300 Making the Election

References 17276.1(a)-(b); 24416.1(a) & (c); Repealed Sections 17276.4(c)-(e); 24416.4(c)-(e)

Qualified taxpayers must make an election to claim the LARZ NOL. The election must be timely filed with the original return, and be for the income or taxable year in which the NOL is incurred. The election is irrevocable.

NOTE: For LARZ businesses, the election to compute the loss under CR&TC § 17276.1 or 24416.1 could have been made on an amended return for the 1992 income year only. The amended return had to be filed by June 30, 1994. FTB Notice 94-1, March 18, 1994.

If the taxpayer is eligible to qualify for an NOL under more than one section (operation in more than one economic development area, new small business etc.), the taxpayer must choose which section to elect. Except for the loss incurred under the subdivision elected, taxpayers are prohibited from carrying over any other type of NOL from the same tax year.

Failure to elect to compute the NOL deduction under section 17276.1 or 24416.1 will cause the NOL to be subject to the limitations and restrictions under section 17276 or 24416 (general NOL).

The taxpayer makes the election by using:

- Form FTB 3806 – Los Angeles Revitalization Zone Deduction and Credit Summary.

In addition, the form FTB 3806 must be filed for each year in which the NOL deduction is taken.

20400 LARZ NOL Computation - General Provisions

References 17276.1(a); 24416.1(a); Repealed Sections 17276.4(a)(2); 24416.4(a)(3)

EDAM 20410 LARZ NOL Limited by General NOL

A LARZ NOL is the loss attributable to the qualified taxpayer's business activities within the LARZ, prior to the LARZ expiration date. LARZ NOLs are determined under IRC § 172, as modified by the following CR&TC §:

- 17276.1
- 17276.4
- 24416.1
- 24416.4

20410 LARZ NOL Limited by General NOL

References 17276; 24416

The LARZ NOL is compared to the NOL computed under the general NOL provisions of section 17276 / 24416, *prior to the 50% reduction*. The LARZ NOL carryover is limited to the lesser of the LARZ NOL or the general NOL (prior to the 50% reduction). **NOTE**: If the LARZ NOL is limited by the general NOL amount, (prior to the 50% reduction), the amount can still be characterized as a LARZ NOL and allowed to be carried over at 100% for 15 years. An election must be made to characterize the NOL as a LARZ NOL.

Example: Corp. B incurred the following loss:

Income from business operations	$160,000
Interest from investment which is unrelated to Corp. B's business operations	15,000
Expenses of business operations	(189,000)
Net loss	**($14,000)**

To determine the NOL carryover attributed to the LARZ business operations, the following must be done:

1. Determine NOL per CR&TC § 24416 (prior to 50% reduction)
2. Determine NOL per CR&TC § 24416.4 (remove non-business items)

The NOL carryover is limited to the lesser of item 1 or item 2 above.

1. CR&TC § 24416 "general" NOL - prior to 50% reduction

Net loss of Corp. B	($14,000)

2. CR&TC § 24416.2 LARZ NOL - exclude non-business income/loss

Income from operations	$160,000
Expenses of operations	(189,000)
Net loss of Corp. B (LARZ)	($29,000)

Pattern 1: Assume Corp. B operates entirely within the LARZ. Corp. B is allowed to carry over the lesser of the "general" NOL, or the LARZ NOL; in this case $14,000.

Pattern 2: Assume Corp. B conducts 40% of its total business operations in the LARZ. Because Corp. B only has 40% of its business operation in the LARZ, the $29,000 business loss must be apportioned before comparing it to the "general" NOL. In this example, the LARZ loss is $11,600 ($29,000 x 40%). Corp. B is allowed to carry over the lesser of the "general" NOL, or the LARZ NOL; in this case, $11,600.

20500 LARZ NOL - Loss Attributed to Business Activity

References (Repealed Sections) 17276.4(a)(2); 24416.4(a)(3)

EDAM 20510	Property Factor – Loss Apportionment
EDAM 20520	Payroll Factor – Loss Apportionment
EDAM 20530	Apportionment – Combined Groups
EDAM 20540	Apportioning for Personal Income Tax Taxpayers

A LARZ NOL is the loss attributable to the qualified taxpayer's business activities within the LARZ prior to the LARZ expiration date. Non-business income and/or loss are excluded from the calculation of the LARZ NOL.

If a business is located within and outside of the LARZ, the taxpayer must determine the portion of the total business loss that is attributable to the LARZ.

- Business loss is defined under the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA).
- Components of the factors are defined under the provisions of UDITPA.

For taxpayers conducting business operations within and without the LARZ, business loss is apportioned to the LARZ by multiplying the worldwide business loss by a fraction, the numerator of which is the property factor plus the payroll factor, and the denominator of which is two (2).

20510 Property Factor – Loss Apportionment

The property factor is a fraction.

- The numerator of the property factor is the average value of the real and tangible personal property owned or rented and used or available for use by the taxpayer *within the LARZ* during the income or taxable year.
- The denominator is the average value of all real and tangible personal property owned or rented and used or available for use during the income or taxable year *worldwide*.

Rented property is valued at eight (8) times the net annual rental rate. The net annual rental rate is the total rent paid for the property, less any subrental rates paid by subtenants.

20520 Payroll Factor – Loss Apportionment

The payroll factor is a fraction.

- The numerator of the payroll factor is the total compensation paid to the taxpayer's employees working within the LARZ during the income or taxable year.
- The denominator is the total compensation paid to employees working *worldwide* during the income or taxable year.

Example - Two-factor apportionment: For the income year ending 12/31/96, Corp. A operates within and outside an LARZ. Corp. A's business loss of $13,000 needs to be apportioned to the LARZ. The following amounts apply to Corp. A's property and payroll:

LARZ Property	$40,000
Worldwide (WW) Property	$100,000
LARZ Payroll	$5,000
WW Payroll	$10,000

LARZ Property/WW Property	=.40	
LARZ Payroll/WW Payroll	=.50	
	.90/2 = .45	LARZ Apportionment Factor

Business loss	$(13,000)
Apportionment Factor	x 0.45
LARZ NOL	$(5,850)

20530 Apportionment – Combined Groups

For members of a combined group, the LARZ NOL calculation is based on the combined groups worldwide business loss (before CA apportionment). The numerator of the apportionment formula will be based on each LARZ taxpayer's separate LARZ payroll and property amounts, and the denominator will be based on the combined groups worldwide payroll and property amounts.

Example: For the income year ending 12/31/96, Parent Corporation A has two subsidiaries, B and C. Corporations A and B operate within the LARZ. The combined group operates within and outside California and apportions its income or loss to California using Schedule R. The combined group's business loss is $1,000,000.

Business loss apportioned to the LARZ was determined as follows:

	A	**B**	**C**	**Combined**
Property Factor				
LARZ Property	$2,000,000	$1,000,000	$0	$3,000,000
Worldwide Property				$5,000,000
Apportionment %	40%	20%		60%
Payroll Factor				
LARZ Payroll	$2,000,000	$800,000	$0	$2,800,000
Worldwide Payroll				$4,000,000
Apportionment %	50%	20%		70%
Average Apport. % (Property + Payroll Factors)/2	45%	20%		65%
Business Loss				$(1,000,000)
LARZ NOL	$(450,000)	$(200,000)		$(650,000)

20540 Apportioning for Personal Income Tax Taxpayers

The following examples show the application of the apportioning rules to personal income tax taxpayers.

Example: Ray Smith is vice president of an S corporation that has two locations, one within the LARZ and one outside the LARZ. Eighty percent (80%) of the S corporation's business is attributable to the LARZ. (**NOTE**: This percentage was determined by the S corporation, using Worksheet V from the FTB 3806 Business Booklet, at the time the S corporation return was prepared). Ray divides his time equally (50% & 50%) between the two offices of the S corporation.

Mary Smith (Ray's spouse) works for the S corporation at its office located in the LARZ.

Ray and Mary Smith have the following items of California income and expense:

Ray's salary from the S corp.	$100,000
Mary's salary from the S corp.	75,000
Interest on savings account	1,000
Dividends	3,000
Schedule K-1(100S) from the S corp.	
Ordinary Loss	200,000
LARZ business expense deduction	(5,000)*
Ray's unreimbursed employee expenses from Schedule A	(2,000)

*The LARZ business expense deduction is a separately stated item on Schedule K-1 (100S).

The Smith's LARZ loss is computed as follows:

Ray's LARZ salary ($100,000 x 50%)	$50,000
Mary's LARZ salary ($75,000 x 100%)	75,000
Pass-through ordinary loss from the S-Corp. ($200,000 x 80%)	(160,000)
LARZ business expense deduction from the S-Corp.	(5,000)
Ray's unreimbursed employee business expenses (2,000 x 50%)	(1,000)
Total LARZ loss	$(41,000)

NOTE: The standard deduction and personal or dependency exemptions are not included in the computation of LARZ NOL since they are not related to trade or business activities.

20600 Carryover / Carryback

References 17276.1(a); 24416.1(a); Repealed Sections 17276.4(a)(1); 17276.4(a)(4); 24416.4(a)(1); 24416.4(a)(2); 24416.4(a)(5)

For each income or taxable year a qualified taxpayer engaged in a trade or business within the designated LARZ may elect to carryover 100% of its NOL. No NOL carrybacks are allowed.

The NOLs may be carried over to each of the 15 income or taxable years following the year of loss, or until exhausted, whichever occurs first. If an NOL carryover remains after the LARZ designation has expired, or for taxpayers operating in the portion of the LARZ that was eliminated during the downsizing, the LARZ is deemed to remain in existence for purposes of computing the LARZ income limitation, and for purposes of allowing the LARZ NOL deduction.

NOTE: Financial institutions, as defined in IRC § 585, 586, or 593, using bad debt reserve methods may carry the loss forward for a maximum of 5 income years.

20700 LARZ NOL Deduction - General Provisions

References (Repealed Sections) 17276.4(a)(3); 17276.4(a)(4); 24416.4(a)(4); 24416.4(a)(5)

EDAM 20710	Business Income Activity Limitation
EDAM 20711	Property Factor – Income Apportionment
EDAM 20712	Payroll Factor – Income Apportionment
EDAM 20713	Apportionment – Combined Groups
EDAM 20714	Apportioning for Personal Income Tax Taxpayers
EDAM 20715	Flow-through Losses

The LARZ NOL deduction can only *offset business income attributable to operations of the taxpayer within the designated LARZ*.

In the event a LARZ NOL deduction is allowable for any taxable or income year after the LARZ designation has expired, or for taxpayers operating in the portion of the LARZ that was eliminated during the downsizing, the LARZ will be deemed to remain in existence for the purpose of computing the business income limitation and allowing an NOL deduction.

20710 Business Income Activity Limitation

References (Repealed Sections) 17276.4(a)(5); 17276.4(a)(5)(A); 24416.4(a)(6); 24416.4(a)(6)(A)

If a business is located within and outside of the LARZ, the taxpayer must determine the portion of the total business income that is attributable to the LARZ.

- Business income is defined under the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA).
- Components of the factors are defined under the provisions of UDITPA.

For income or taxable years beginning on or after January 1, 1994, business income is apportioned to the LARZ by multiplying the taxpayer's total California source business income by a fraction, the numerator of which is the property factor plus the payroll factor, and the denominator of which is two (2).

For income or taxable years beginning on or after January 1, 1992, and before January 1, 1994, business income is apportioned to the LARZ by multiplying the worldwide business income by a fraction, the numerator of which is the property factor plus the payroll factor, and the denominator of which is two (2).

20711 Property Factor – Income Apportionment

The property factor is a fraction. The numerator of the property factor is the average value of the real and tangible personal property owned or rented and used or available for use by the taxpayer *within the LARZ* during the income or taxable year.

- For income or taxable years beginning on or after January 1, 1994, the denominator is the average value of all real and tangible personal property owned or rented and used or available for use by the taxpayer during the income or taxable year *within California*.
- For income or taxable years beginning before January 1, 1994, the denominator is the average value of all real and tangible personal property owned or rented and used or available for use during the income or taxable year *worldwide.*

Rented property is valued at eight (8) times the net annual rental rate. The net annual rental rate is the total rent paid for the property, less any subrental rates paid by subtenants.

20712 Payroll Factor – Income Apportionment

The payroll factor is a fraction. The numerator of the payroll factor is the total compensation paid to the taxpayer's employees working within the LARZ during the income or taxable year.

- For income or taxable years beginning on or after January 1, 1994, the denominator is the total compensation paid to employees working for the taxpayer *in California* during the income or taxable year.
- For income or taxable years beginning before January 1, 1994, the denominator is the total compensation paid to employees working *worldwide* during the income or taxable year.

Example: Two-factor apportionment: For the income year ending 12/31/97, Corp. A operates within and outside an LARZ. California business income of $13,000 needs to be apportioned to the LARZ. The following amounts apply to Corp. A's property and payroll:

LARZ Property	$40,000
CA Property	$100,000
LARZ Payroll	$5,000
CA Payroll	$10,000

LARZ Property/CA Property	=.40	
LARZ Payroll/CA Payroll	=.50	
	.90/2 = .45	LARZ Apportionment Factor

Business income	$13,000
Apportionment Factor	x 0.45
LARZ Business Income	$5,850

20713 Apportionment – Combined Groups

For income or taxable years beginning before January 1, 1994: For members of a combined group, the income limitation will be based on the combined groups worldwide business income (before CA apportionment). The numerator of the apportionment formula will be based on each LARZ taxpayer's separate LARZ payroll and property amounts, and the denominator will be based on the combined groups worldwide payroll and property amounts.

For an example of apportionment under this method refer to EDAM 23440.

For income or taxable years beginning on or after 1/1/1994: For members of a combined group, the limitation will be based on the intrastate apportioned business income for each taxpayer doing business within the LARZ. The numerator of the apportionment formula will be based on each LARZ taxpayer's separate LARZ property and payroll amounts and the denominator will be based on each LARZ taxpayer's separate California property and payroll amounts.

Example: For the income year ending 12/31/97, parent corporation A has two subsidiaries, B and C. Corporations A and B operate within the LARZ. The combined group operates within and outside California and apportions its income to California using Schedule R. The combined group's business income apportioned to California was $1,000,000. Corporation A and B's share of California business income is $228,000 and $250,000 respectively. Corporation A and B's separate LARZ and separate California property and payroll factor amounts are shown below.

Business income apportioned to the LARZ was determined as follows:

	A	**B**
<u>Property Factor</u>		
LARZ Property	$1,000,000	$ 800,000
California Property	$1,000,000	$1,200,000
Apportionment %	100%	66.66%
<u>Payroll Factor</u>		
LARZ Payroll	$800,000	$ 800,000
California Payroll	$800,000	$1,000,000
Apportionment %	100%	80%
Average Apport. % (Property + Payroll Factors)/2	100%	73.33%

Apportioned Business Income	$228,000	$250,000
LARZ Income	$228,000	$183,333

20714 Apportioning for Personal Income Tax Taxpayers

The following examples show the application of the apportioning rules to personal income tax taxpayers.

Example: Ray Smith is vice president of an S corporation that has two locations, one within an LARZ and one outside the LARZ. Eighty percent (80%) of the S corporation's business is attributable to the LARZ. (**NOTE**: This percentage was determined by the S corporation, using Worksheet V from the FTB 3806 Business Booklet, at the time the S corporation return was prepared). Ray divides his time equally (50% & 50%) between the two offices of the S corporation.

Mary Smith (Ray's spouse) works for the S corporation at its office located in the LARZ.

Ray and Mary Smith have the following items of California income and expense:

Ray's salary from the S corp.	$100,000
Mary's salary from the S corp.	75,000
Interest on savings account	1,000
Dividends	3,000
Schedule K-1(100S) from the S corp.	
Ordinary income	40,000
LARZ business expense deduction	(5,000)*
Ray's unreimbursed employee expenses from Schedule A	(2,000)

*The LARZ business expense deduction is a separately stated item on Schedule K-1 (100S).

The Smith's LARZ income is computed as follows:

Ray's LARZ salary ($100,000 x 50%)	$50,000
Mary's LARZ salary ($75,000 x 100%)	75,000
Pass-through ordinary income from the S-Corp. ($40,000 x 80%)	32,000
LARZ business expense deduction from the S-Corp.	(5,000)
Ray's unreimbursed employee business expenses (2,000 x 50%)	(1,000)
Total LARZ income	$151,000

NOTE: The standard deduction and personal or dependency exemptions are not included in the computation of LARZ income since they are not related to trade or business activities

20715 Flow-through Losses

References 17087.5; 17087.6; 17851; 23800; 24271

The income and loss that will flow through to a shareholder, beneficiary, partner, or member, retains the same characteristics as it had with the pass-through entity.

The election to claim an NOL must be made by the entity and each investor on their respective returns. The election by the entity to utilize the LARZ NOL does not extend to, or bind the investor to utilizing the LARZ NOL. Further, the investor may utilize the LARZ NOL if the entity utilized the general NOL provisions, or had no NOL. Each taxpayer must determine if they in fact have a NOL, and then decide whether the general or LARZ NOL will be utilized.

20800 NOL Suspensions

References 17276.3(c); 24416.3(c)

For taxable years beginning in 2002 and 2003, California has suspended the Net Operating Loss (NOL) carryover deduction. Taxpayers may continue to carryover an NOL during the suspension period. The carryover period for suspended losses is extended by two years for losses incurred before January 1, 2002. The deduction for disaster losses is not affected by the NOL suspension rules.

NOLs incurred by qualified taxpayers are *not* suspended for taxable or income years beginning in 1991 and 1992.

20900 Alternative Minimum Tax

References 17062; 23456

Taxpayers claiming an LARZ NOL deduction must also determine their NOL for alternative minimum tax purposes.

Section 21000 LOS ANGELES REVITALIZATION ZONE NET INTEREST DEDUCTION

References (Repealed Sections) 17233; 24385

The Los Angeles Revitalization Zone (LARZ) was established to aid economic development in areas that suffered damage during the civil unrest that occurred in the County of Los Angeles during April and May 1992. The LARZ became operative on May 1, 1992, and applied to businesses with taxable or income years beginning on or after January 1, 1992. The LARZ expired on December 1, 1998.

California Revenue & Taxation Code Sections (CR&TC §) 17233 and 24385 provide for the deduction of net interest income for loans made to a trade or business located solely within the LARZ. The net interest deduction is for interest payments received in income or taxable years beginning on or after January 1, 1992, and after May 1, 1992, and on or before November 30, 1998, whether a calendar or fiscal year taxpayer.

21100 Geographic Boundaries

For a listing of LARZ cities, see "LARZ *Locations and Designation Dates*" EDAM 1350. To verify an address, refer to EDAM 1300.

NOTE: Effective 1/1/96, the LARZ geographic area was re-determined (downsized) to eliminate previously qualified addresses. For taxpayers that operate in the portion of the LARZ that was excluded when the LARZ was downsized, LARZ benefits that were incurred when the LARZ designation was effective are allowed after downsizing (carryover amounts). In regards to the applicability of LARZ benefits incurred after the downsize of the LARZ, the net interest deduction is no longer available, as of the first day of the income or taxable year beginning on or after January 1, 1996, the determination date.

21200 Qualified Taxpayer

References (Repealed Sections) 17233(a); 24385(a)

EDAM 21210 Pass-Through Entities

For purposes of the LARZ net interest deduction, a qualified taxpayer includes a person or entity (creditor) that loans funds on or after 5/1/92, to a qualified business/debtor and receives interest payments thereon. The loan advanced to the qualified business/debtor must also meet the requirements as discussed in EDAM 21300.

The creditor does not have to be located in the LARZ to take advantage of the net interest deduction. Only the debtor needs to operate in the LARZ.

21210 Pass-Through Entities

The determination of whether a taxpayer is a qualified taxpayer is made at the entity level.

21300 Qualified Debt

References (Repealed Sections) 17233(b); 24385(b)

EDAM 21310 Security/Collateral

To claim the net interest deduction for creditors, the following requirements must be met at the time the indebtedness is incurred:

- The trade or business (qualified business/debtor) to which the loan is made, must be located solely within the LARZ;
- The indebtedness is incurred solely in connection with activity within the LARZ; and
- The creditor has no equity or other ownership interest in the debtor.

  NOTE: Repealed Sections 17233(b)(3) & 24385(b)(3) require that the creditor have no equity or other ownership interest in the debtor at the time the loan is made. However, the CR&TC does not provide for any limitation after the loan is made. For example, assume that two years after the qualified loan is made the debtor contacts the creditor to renegotiate the loan terms due to the debtor's poor financial condition. The creditor agrees to take an equity interest in the debtor in exchange for reducing the amount due from the debtor. Net interest received from the remaining portion of the qualified loan would still be deductible.

To claim the net interest deduction for creditors, the following requirements must be met annually:

- The qualified business/debtor, which the loan was made to and interest payments are received from, must be conducting business in the LARZ.

Example: Two years after the qualified loan is funded, the qualified business/debtor moves their operations entirely outside of the LARZ geographic boundaries. The net interest deduction is no longer allowed because the trade or business is not located within the designated LARZ.

21310 Security/Collateral

The statute does not require that the security or collateral for the loan be located in the LARZ. For example, a sole proprietor can use its personal residence as collateral for the LARZ business loan and the creditor is still allowed the net interest deduction assuming all other qualifications are met.

21400 Definition of "Qualified Business/Debtor"

The definition of a *qualified business/debtor* in Section 7102 of the Government Code requires inquiry at the entity level. The business activity of the entity (entirely or a portion thereof as relevant) must be conducted within the LARZ.

21500 Definition of a "Trade or Business"

Black's Law Dictionary defines *trade or business* as follows:

"Any business or professional activity conducted by a taxpayer, the objective of which is to earn a profit. The general test for determining whether a person is engaged in "trade or business" so as to be entitled to deduct expenses as trade or business expenses under the Internal Revenue Code is whether the taxpayer's primary purpose and intention in engaging in the activity are to make a profit."

21600 Definition of "Located Solely Within"

References (Repealed Sections) 17233(b)(1); 24385(b)(1)

In order to claim the net interest deduction, the loan must be made to a qualified business/debtor *located solely within* the LARZ. Generally, one looks to the presence of tangible property in order to determine the place, site, or limits of a business. Intangible property by definition cannot be located by reference to physical presence. The presence of all of the qualified trade or business' payroll and tangible property within the LARZ would be a strong indication that they meet the test. The fact that sales are delivered by common carrier outside of the LARZ should not cause the debtor to fail the "*located solely within*" requirement.

21700 Net Interest Deduction – Computation

For purposes of determining the net interest deduction, *net interest* is gross interest received less related interest expense (cost of funds) and any other directly related expenses.

21710 Gross Interest

There may be substantial differences between tax and book accounting methods. Consequently, the amount of gross interest income included in the computation of net interest must be determined using the creditor's tax accounting method (i.e., the gross interest income included in the computation of net interest corresponds to the gross interest income included in the determination of taxable income). Gross interest income should not include items that are not in the nature of interest.

Interest is defined as an amount paid for the use or forbearance of money.

Gross interest may be determined by referencing the loan contract. A contract between a creditor and a qualified business/debtor may include all of the following:

- A stated rate of interest;
- Points;
- Commitment fees (fees for entering into an agreement that obligates the lender to make funds available for an agreed period at a stated rate of interest - see Rev. Rul. 70-540)*;
- Service fees (fee charged for processing a loan); and
- Escrow interest.

Analysis of each of the above items is necessary to determine which are in the nature of interest. For example, commitment fees and service fees should not be included in gross interest for purposes of determining the net interest deduction as they are fees earned when establishing the loan and are not monies paid for the use of the loaned funds.

Points are a charge by the lender, in addition to the stated rate of interest, to reflect the actual cost of borrowing money. Thus, points as here described, are for the use or forbearance of money and are considered to be interest. Escrow interest is interest from the date the loan is funded until 30 days before the borrower's first loan payment. Original issue discount (OID) is another form of interest. Stated interest, points, escrow interest, and OID are all items that may be included in gross interest for purposes of determining the net interest deduction.

***NOTE:** Revenue Ruling 70-540, 1970-2 CB 101 discusses the character of commitment fees from the lender's point of view. The commitment fee is a charge for agreeing to make funds available rather than for the use or forbearance of money, and therefore, is not interest. Other revenue rulings discuss commitment fees from the point of view of the borrower. To the extent of any discussion concerning the treatment of points by the lender, Rev. Rul. 70-540 was made obsolete by Rev. Proc. 94-29, 1994-1 CB 616; this does not effect its relevance in regards to commitment fees.

21720 Cost of Funds

A reasonable amount of interest expense must be assigned to the interest income. One method of determining a reasonable cost of funds would be the following formula:

$$\frac{\text{Interest Expense}}{\text{Funding Sources}} = \text{Cost of Funds}$$

Funding sources are equal to average liabilities plus owners' equity less average non-interest earning assets.

The ratio from the above formula is multiplied by the average loan principal outstanding for the year. All amounts should be on a tax basis.

For example, assume the following is from the tax return of a financial institution:

Average liabilities and owners’ equity	$53,000,000,000	
LESS: Average non-interest earning assets	7,000,000,000	
Funding Sources	$46,000,000,000	
Total Interest Expense	$1,500,000,000	
Funding Sources	$46,000,000,000	= 3.26%

Assume that an average principal amount of $10 million was outstanding during the year for loans made to businesses within the LARZ. A reasonable amount of interest expense to assign to the loans is $326,000 ($10 million times 3.26%).

Taxpayers may also use an independent cost of funds index such as the prime index rate or the London Interbank Offered Rate (LIBOR), which is the rate banks use to place Eurodollars with one another in London. If an independent index is used, that index must approximate the taxpayer's cost of funds.

The annual report of many banks or savings and loan associations provides the average cost of funds. The net interest margin (the difference between interest income and interest expense) is usually of interest to shareholders and other users of the annual report. The net interest margin should be similar to that used for the calculation of the net interest deduction.

21730 Other Related Expenses

"Net interest" is interest received less the cost of funds and direct expenses incurred in earning such interest. An example of a direct expense is commission paid to a loan representative. Expenses that are not directly attributable to the loan in question should not be subtracted for purposes of determining the net interest deduction.

All reasonably identifiable direct costs applicable to acquiring or making a loan should be capitalized and written off over the life of the loan. The amortization method should reflect the nature of the loan. It would be reasonable to use straight line or principal reduction methods of amortization (see Rev. Proc. 94-29 for application of the principal reduction method).

21740 Non-Bank & Non-Financial Lenders

Non-financial corporations and individuals usually do not have all of the various income and expense items referred to previously.

Generally, gross interest of non-bank or non-financial creditors will be the interest income as stated in the loan. For example, an individual creditor will generally avoid escrow interest by establishing the monthly due date of the loan as the day of the month the loan was funded, or the day escrow closed, whereas mortgages carried by a commercial lender generally have a common due date, i.e., the beginning of the month.

Related expenses, such as the cost of funds, must be determined in order to compute the deduction of net interest income. Non-bank or non-financial lenders who make loans to qualified businesses located solely within the LARZ may incur investment interest expense related to such loans. The interest tracing rules under Treas. Reg. 1.163-8T are appropriate for determining related interest expense for these taxpayers.

21800 Expiration Of LARZ Designation

References 17233; 24385

Once the LARZ designation expires, becomes inoperative, or ceases to exist, the net interest deduction is not allowed because the trade or business is no longer located within the designated LARZ.

21900 Record Keeping

The qualified taxpayer/creditor should maintain records on each loan (loan agreements) for which a deduction of net interest is taken. The records should identify or describe:

- The debtor,
- The debtor's location (at the time of indebtedness and annually),
- The debtor's mailing address,
- The purpose/use of the loan,
- The stated interest,
- Other items included in gross interest,
- Any direct expenses associated with the loan, and
- Any property securing the loan.

Section 22000 PROGRAM AREA HIRING CREDIT

References (Repealed Sections) 17053.11; 23623

Program Areas converted to Enterprise Zones as of January 1, 1997. Prior to this date, taxpayers had to be certified by the California Trade and Commerce Agency or TCA in order to be eligible to utilize the Program Area tax incentives. TCA could certify a taxpayer to take the hiring credit only or all five Program Area incentives. The type of certification is determined from the certification letter.

Certification was generally valid for three years. After three years, the taxpayer would have to be re-certified. De-certification could occur if a company failed to meet the requirements.

The Program Area hiring credit applies to those employees hired after the designation date of the Program Area. No credit is allowed for employees hired after the Program Area designation expires. However, for income and taxable years beginning on or after January 1, 1997, Program Areas were converted to Enterprise Zones (EZs) and are entitled to the benefits available to EZs (see EDAM 2000 - 7000).

The following Program Area discussion relates to income and taxable years beginning prior to January 1, 1997.

22100 Geographic Boundaries and Designation Dates

For a listing of Program Area cities, see "Program Area Locations and Designation Dates " EDAM 1360. To verify an address, refer to EDAM 1300.

22200 Qualified Business

References (Repealed Sections) 17053.11(b)(1); 23623(b)(1)

EDAM 22210 Change in the Form of the Trade or Business

A "qualified business" *eligible for all five* of the Program Area tax incentives, is a business certified during the income or taxable year as meeting one of the following standards based on its *total work force* in the Program Area:

- 50% of its Program Area work force are residents of a high density unemployment area (HDUA); or
- 30% of its Program Area work force are residents of a HDUA and the company must contribute to an approved community service program;

The business may also qualify if persons owning at least 30% of the business are residents of a HDUA.

A "qualified business" *eligible for the hiring credit only*, is a business certified during the income or taxable year as meeting one of the following standards *based ONLY on those employees hired by the business in the Program Area within the 12 months period immediately preceding the date certification is sought*:

- 50% of its Program Area work force are residents of a high density unemployment area (HDUA); or
- 30% of its Program Area work force are residents of a HDUA and the company must contribute to an approved community service program;

The business may also qualify if persons owning at least 30% of the business are residents of a HDUA.

22210 Change in the Form of the Trade or Business

References (Repealed Sections) 17053.11(f)(2)(F); 23623(f)(2)(F)

The employment relationship between the taxpayer and an employee is not treated as terminated by reason of a mere change in the form of conducting the trade or business. If the employee continues employment in that trade or business and the taxpayer retains a substantial interest in that trade or business, the employee is not treated as terminated.

22300 Qualified Wages

References (Repealed Sections) 17053.11(e); 23623(e)

EDAM 22310 Estates and Trust
EDAM 22320 Minimum Wage Chart

Qualified wages are wages paid or incurred to employees (qualified) during the consecutive 60-month period beginning with the first day the employee commences employment with the taxpayer.

In general, *qualified wages* means that portion of hourly wages that does not exceed 150% of the minimum wage.

- Minimum wage means the wage established by the Industrial Welfare Commission. When the California minimum wage is higher than federal minimum wage, use the California minimum wage for purposes of this credit.
- To determine a salaried employee's hourly wage, divide the total salary by the average hours worked, normally 2,000 hours per year.

22310 Estates and Trust

In the case of an estate or trust, the qualified wages are apportioned between the estate/trust and the beneficiaries on the basis of the income allocable to each. Consequently, any beneficiary, to whom wages are apportioned, is treated as the employer with respect to those wages.

22320 Minimum Wage Chart

EFFECTIVE DATE	MINIMUM WAGE	MAXIMUM HOURLY WAGE - HIRING CREDIT
July 1, 1988 to September 30, 1996	$4.25	$6.37 (150% of $4.25)
October 1, 1996 to February 28, 1997	$4.75	$7.12 (150% of $4.75)
March 1, 1997 to August 31, 1997	$5.00	$7.50 (150% of $5.00)
September 1, 1997 to February 28, 1998	$5.15	$7.72 (150% of $5.15)

22400 Qualified Employee

References (Repealed Sections) 17053.11(b)(2); 17053.11(c); 17053.11(d); 23623(b)(2); 23623(c); 23623(d)

EDAM 22410 Leased Employees

A *qualified employee* is an individual who was an unemployed resident of a HDUA, for three or more months prior to employment with the qualified business. Participation by a prospective employee in a state or federally funded job training or work demonstration program does not constitute employment, or affect the eligibility of an otherwise qualified employee.

A *qualified employee* also includes an otherwise qualified individual who is employed by a qualified business in the 90 days prior to the business' certification by the TCA.

22410 Leased Employees

The "employer" is the qualified taxpayer and may qualify for the hiring credit for leased employees. The employer can be either the leasing company or the subscriber to the leasing company. Generally, the employer can be identified due to the legal obligation to pay the payroll taxes of the employee, and as to who has the right to control and direct the workers (employee's) services.

Internal Revenue Service (IRS) Publication 15-A, *Employer's Supplemental Tax Guide* provides guidelines for establishing an employment relationship and provides examples to consider in determining the employer-employee relationship.

22500 Credit Computation

References (Repealed Sections) 17053.11(a); 17053.11(c) & (d); 23623(a); 23623(c) & (d)

For each income or taxable year a hiring credit is allowed to a qualified business for hiring a qualified employee who was unemployed for *at least six (6) months*. The credit is equal to the sum of each of the following:

- 50% of the qualified wages during the first year of employment.
- 40% of the qualified wages during the second year of employment.
- 30% of the qualified wages during the third year of employment.
- 20% of the qualified wages during the fourth year of employment.
- 10% of the qualified wages during the fifth year of employment.

For those qualified employees unemployed for at least three (3) months but less than six (6) months, the credit is equal to the sum of the following:

- 25% of the qualified wages during the first year of employment.
- 40% of the qualified wages during the second year of employment.
- 30% of the qualified wages during the third year of employment.
- 20% of the qualified wages during the fourth year of employment.
- 10% of the qualified wages during the fifth year of employment.

The credit percentage is based on the employee's date of employment and subsequent anniversary dates. The taxpayer's tax year does not control the applicable credit percentages. With the exception of the first and last year of the credit, within one tax year, two percentage ranges for the computation of the credit may apply.

> ***Example***: An employee was hired 7/1/1995, and the taxpayer is completing the tax return for the year ending 12/31/1996. For the period 1/1/1996 to 6/30/1996, the hiring credit is based on 50% of qualified wages. For the period 7/1/1996 to 12/31/1996, the hiring credit is based on 40% of qualified wages.

Once the employee commences employment, the credit percentage range begins and generally is not interrupted in the event of a subsequent layoff and rehire of the employee.

> ***Example***: An employee is hired 7/1/1995, is temporarily laid off 2/1/1996, and is rehired 4/1/1996. The 50% credit range runs from 7/1/1995 to 6/30/1996 regardless of the layoff period between 2/1/1996 and 3/31/1996.

22510 Reduction for Other Tax Credits

References (Repealed Sections) 17053.11(h); 23623(g)

The Program Area hiring credit is reduced by the credit allowed under California Revenue & Taxation Code Section (CR&TC §) 17053.7 & 23621 (Jobs Tax Credit), and the federal credit allowed under IRC §51 (Work Opportunity Tax Credit – WOTC).

22520 Wage Expense Deduction

References (Repealed Sections) 17053.11(h); 23623(g)

The taxpayer must reduce any deduction for wages by the amount of the Program Area hiring credit allowed (including any current year credit carried forward).

22530 Business Income Activity Limitation

References (Repealed Sections) 17053.11(j); 23623(i)

The amount of hiring credit or sales or use tax credit (see EDAM 23000) claimed, including any credit carryover from prior years, may not exceed the amount of tax on the taxpayer's Program Area business income in any year. The Program Area business income is that portion of *worldwide* business income that is apportioned to the Program Area. Non-business income or loss is not included in the calculation of business income from the Program Area. Each taxpayer claiming the credit must compute the Program Area business income and resulting tax.

Example: Corp. A operates entirely within a Program Area. In order to determine the amount of hiring credit allowable, the business income and the tax on that business income must be determined. Corp. A has the following items of income and expense:

Income from business operations	$30,000
Interest from investment which is unrelated to Corp. A's business operations	2,000
Business expenses	(17,000)
Net taxable income before taxes	$15,000

Corp. A's income attributed to business operations is:

Income from business operations	$30,000
Business expenses	(17,000)
Net Business Income	$13,000

To determine the Program Area hiring credit allowable, the net business income is multiplied by the current tax rate.

Net Business Income	$13,000
x 9.3%	.093
Tax associated with business income	$1,209

In this example, the taxpayer can offset the tax of $1,209 with the hiring credit available (up to $1,209).

NOTE: "net tax"/"tax" and alternative minimum tax impose limitations on the allowable offset but were not considered a factor in this example.

22540 General Provisions – Apportionment of Business Income

References (Repealed Sections) 17053.11(j)(2); 23623(i)(2)

If a business is located within and outside of a Program Area, or in more than one Program Area, the taxpayer must determine the portion of the total business income that is attributable to each Program Area.

- Business income is defined under the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA).
- Components of the factors are defined under the provisions of UDITPA.

For income or taxable years beginning on or after January 1, 1991, and ending on or before December 31, 1996 (1991 - 1995 years and 1996 calendar year taxpayers), business income is apportioned to the Program Area by multiplying the *worldwide* business income by a fraction, the numerator of which is the property factor plus the payroll factor, and the denominator of which is two (2).

For 1996 fiscal years, income or loss attributed to the Program Area is determined by multiplying *worldwide* business income or loss by a fraction, the numerator of which is the property factor, payroll factor, and sales factor (double weighted), the denominator of which is four (4).

For income or taxable years beginning before January 1, 1991, income or loss attributed to the Program Area is determined by multiplying *worldwide* business income or loss by a fraction, the numerator of which is the property factor, payroll factor, and sales factor, the denominator of which is three (3).

22541 Property Factor – Income Apportionment

References (Repealed Sections) 17052.13(f) 23612(f)

The property factor is a fraction. The numerator of the property factor is the average value of the real and tangible personal property owned or rented and used or available for use by the taxpayer *within the Program Area* during the income or taxable year. The denominator is the average value of all real and tangible personal property owned or rented and used or available for use during the income or taxable year *worldwide*.

Rented property is valued at eight (8) times the net annual rental rate. The net annual rental rate is the total rent paid for the property, less any subrental rates paid by subtenants.

22542 Payroll Factor – Income Apportionment

References (Repealed Sections) 17052.13(f) 23612(f)

The payroll factor is a fraction. The numerator of the payroll factor is the total compensation paid to employees working for the taxpayer *within the Program Area* during the income or taxable year. The denominator is the total compensation paid to employees working *worldwide* during the income or taxable year.

22543 Sales Factor – Income Apportionment

The sales factor is a fraction. The numerator of the sales factor is composed of the gross receipts as defined under the provisions of CR&TC §25134 - 25136, derived during the taxable or income year from transactions and activities occurring within the taxpayers trade or business in the Program Area. The denominator is composed of the gross receipts as defined under the provisions of CR&TC §25134 - 25136, derived during the taxable or income year from transactions and activities related to worldwide operations

General rules regarding the double weighting of the sales factor are applicable.

Example: For the income year ending 12/31/95, Corporation A operates within and outside a Program Area. Total business income of $13,000 needs to be apportioned to the Program Area. The following amounts apply to Corp. A's property and payroll:

Program Area Property	$40,000
WW Property	$100,000
Program Area Payroll	$5,000
WW Payroll	$10,000

Program Area Property/WW Property	=.40	
Program Area Payroll/WW Payroll	=.50	
	.90/2 = .45	Program Area Apportionment Factor

Business income	$13,000
Apportionment Factor	x 0.45
Program Area Business Income	$5,850
Current Tax Rate (Prior to 1997 – 9.3%)	x 0.093
Tax attributable to Program Area business income	$544

22544 Apportionment – Combined Groups

For members of a combined group, the credit limitation will be based on the combined groups worldwide business income (before CA apportionment). The numerator of the apportionment formula will be based on each Program Area taxpayer's separate Program Area payroll and property amounts (and sales as discussed in EDAM 22543) and the denominator will be based on the combined groups worldwide payroll and property amounts (and sales as discussed in EDAM 22534).

Example: For the income year ending 12/31/95, Parent Corporation A has two subsidiaries, B and C. Corporations A and B operate within a Program Area. The combined group operates within and outside California and apportions its income to California using Schedule R. The combined group's business income is $1,000,000.

Business income apportioned to the Program Area was determined as follows:

	A	**B**	**C**	**Combined**
Property Factor				
Program Area Property	$2,000,000	$1,000,000	$0	$3,000,000
Worldwide Property				$5,000,000
Apportionment %	40%	20%		60%
Payroll Factor				
Program Area Payroll	$2,000,000	$800,000	$0	$2,800,000
Worldwide Payroll				$4,000,000
Apportionment %	50%	20%		70%
Average Apport. % (Property + Payroll Factors)/2	45%	20%		65%
Business Income				$1,000,000
Program Area Income	$450,000	$200,000		$650,000

22545 Apportioning for Personal Income Tax Taxpayers

The following examples show the application of the apportioning rules to personal income tax taxpayers.

Example: Ray Smith is vice president of an S corporation that has two locations, one within a Program Area and one outside the Program Area. Eighty percent (80%) of the S corporation's business is attributable to the Program Area. (**NOTE**: This percentage was determined by the S corporation, using Worksheet V from the FTB 3805Z Business Booklet, at the time the S corporation return was prepared). Ray divides his time equally (50% & 50%) between the two offices of the S corporation.

Mary Smith (Ray's spouse) works for the S corporation at its office located within the Program Area.

Ray and Mary Smith have the following 1996 items of California income and expense:

Ray's salary from the S corp.	$100,000
Mary's salary from the S corp.	75,000
Interest on savings account	1,000
Dividends	3,000
Schedule K-1(100S) from the S corp.	
Ordinary income	40,000
Program Area business expense deduction	(5,000)*
Ray's unreimbursed employee expenses from Schedule A	(2,000)

*The Program Area business expense deduction is a separately stated item on Schedule K-1 (100S).

The Smith's Program Area income is computed as follows:

Ray's Program Area salary ($100,000 x 50%)	$50,000
Mary's Program Area salary ($75,000 x 100%)	75,000
Pass-through ordinary income from the S-Corp. ($40,000 x 80%)	32,000
Program Area business expense deduction from the S-Corp.	(5,000)
Ray's unreimbursed employee business expenses (2,000 x 50%)	(1,000)
Total Program Area income	$151,000

Ray and Mary must compute the tax on the total Program Area income of $151,000 (as if it represents all of their income). Using the tax rate schedule for the filing status *married filing joint*; the 1996 tax on $151,000 is $10,938. The $10,938 is the first limitation on Program Area credits for the 1996 tax year. The second limitation on the credits is the *net tax* on all income.

NOTE: The standard deduction and personal or dependency exemptions are not included in the computation of Program Area income since they are not related to trade or business activities.

22550 S Corporations

References 23803(a)(1)(A); 23803(a)(1)(F)

An S corporation's hiring credit may reduce the Program Area tax at both the corporate and shareholder levels. However, the S corporation may only use one-third (1/3) of the credit to reduce the tax on the S corporation's Program Area income.

One hundred percent (100%) of the Program Area credit is passed through to the S corporation shareholders. The full amount of the credit is reported on Schedule K (100S) and passed through to the shareholders on Schedules K-1 (100S).

The wage reduction for the S corporation is equivalent to the 1/3 credit amount. The wage reduction for the shareholders is 100% of the credit amount, equal to the amount of credit passing through to them.

Example: An S Corporation computes a $3,000 hiring credit. The S corporation's credit is $1,000 and the wage reduction is $1,000. The $3,000 credit is passed through to the S corporation's shareholders, and the wage reduction recognized by the shareholders is $3,000.

22600 Credit Usage & Carryover

References (Repealed Sections) 17053.11(i); 17053.11(j)(1); 17053.11(j)(3); 23623(h); 23623(i)(1); 23623(i)(3)

EDAM 22610 Credit Will Not Reduce Certain Taxes
EDAM 22620 Credit Recapture
EDAM 22621 Credit Recapture – Exceptions

The total amount of Program Area hiring and sales or use tax credits, including any credit carryover from prior years, that may reduce the "net tax"/"tax" for the income or taxable year, shall not exceed the amount of tax imposed on the taxpayer's business income attributable to the Program Area, determined as if that income represented all of the income of the taxpayer.

The portion of the credit that exceeds the "net tax"/"tax" for the income or taxable year, is carried over and added to the credit, if any, in the following year. The credit is carried over to succeeding years, until it is exhausted.

Example: A taxpayer has a $4,900 Program Area hiring credit. Tax imposed on Program Area business income is $4,700 and the taxpayer's overall "net tax"/"tax" is $4,000. The taxpayer would be eligible to claim a $4,000 maximum hiring credit.

Total hiring credit	$4,900
Tax on Program Area income	$4,700
First limitation:	
Lesser of total credit or tax on Program Area income	$4,700
Second limitation:	
Lesser of tax on Program Area income or "*net tax*"/"*tax*"	$4,000
Maximum credit allowed:	
Lesser of *Program Area tax limitation* or "*net tax*"/"*tax*" *limitation*	$4,000
Total hiring credit	$4,900
Maximum credit allowed	$4,000
Carryover	$ 900

22610 Credit Will Not Reduce Certain Taxes

The Program Area hiring credit cannot reduce the:

- Minimum franchise tax (corporations, limited partnerships, limited liability partnerships, LLCs, and S corporations);
- Built-in gains tax (S corporations);
- Excess net passive income tax (S corporation);
- Alternative minimum tax (corporations, exempt organizations, individuals and fiduciaries); or
- Regular tax below tentative minimum tax (TMT) before January 1, 1993

NOTE: For income or taxable years beginning on or after January 1, 1993, the Program Area hiring credit may reduce regular tax below TMT.

22620 Credit Recapture

References (Repealed Sections) 17053.11(f)(1); 17053.11(f)(3); 23623(f)(1); 23623(f)(3)

Recapture of the hiring credit is required if the employee is terminated before the end of the longer of the following two periods:

- The first 270 days of employment (whether or not consecutive); or
- Ninety (90) days of employment plus 270 calendar days,

A ‘‘day of employment’’ includes any day the employee was paid to work, regardless of whether the employee actually worked (including paid holidays, sick days, and vacation days).

To recapture the credit, the taxpayer must add to the current year's tax the amount of credit claimed for the year of termination, as well as all prior year credit claimed for the terminated employee.

NOTE: Any increase in tax, due to credit recapture, cannot be offset by the current year hiring credit.

22621 Credit Recapture – Exceptions

References (Repealed Sections) 17053.11(f)(2); 23623(f)(2)

Credit recapture will not apply if the termination was:

- Voluntary on the part of the employee;
- Caused by the employee becoming disabled;
- Due to employee misconduct;
- Due to a substantial reduction in business; or
- In order to enable other qualified employees to be hired, creating an increase in the number of qualified employees and the hours of employment.

22700 Record Keeping Requirements

For each qualified employee, documentation should be kept to show the following:

- Employee name
- Date employee was hired
- Number of hours the employee worked for each month of employment
- Wage rate paid for each month of employment
- Schedule calculating the hiring credit
- Overtime hours
- Location where services were performed
- Date employee was terminated, and reason why

Section 23000 PROGRAM AREAS SALES OR USE TAX CREDIT

References (Repealed Sections) 17052.13(a), (b); 23612(a), (b)

Program Areas converted to Enterprise Zones as of January 1, 1997. Prior to this date, taxpayers had to be certified by the California Trade and Commerce Agency or TCA in order to be eligible to utilize the Program Area tax incentives. TCA could certify a taxpayer to take the hiring credit only or all five Program Area incentives. The type of certification is determined from the certification letter.

Certification was generally valid for three years. After three years, the taxpayer would have to be re-certified. De-certification could occur if a company failed to meet the requirements.

A taxpayer certified by TCA to claim all five Program Area tax incentives, and operating in a Program Area, can take a credit for the sales or use tax paid or incurred in connection with the purchase of qualified property.

- In any year, individuals may claim a credit equal to the sales or use tax paid or incurred on the purchase of the first $1 million of qualified property.
- In any year, corporations may claim a credit equal to the sales or use tax paid or incurred on the purchase of the first $20 million of qualified property. (See special rule for S corporations and shareholders in EDAM 23500)

No credit may be claimed for property purchased after the Program Area designation expires.

23100 Geographic Boundaries and Designation Dates

For a listing of Program Area cities, see "Program Area Locations and Designation Dates " EDAM 1360. To verify an address, refer to EDAM 1300.

23200 Qualified Business

References (Repealed Sections) 17052.13(b)(1)(A); 23612(b)(1)(A)

EDAM 23210 Pass-Through Entities

A "Qualified Business" is a person or entity certified by TCA and engaged in a trade or business within a Program Area. A taxpayer does not qualify for the Program Area tax incentives, if they fail to be certified.

23210 Pass-Through Entities

The determination of whether a taxpayer is a qualified taxpayer is made at the entity level. The term "pass-through entity" means any partnership or S corporation. The sales or use tax credit is allowed to the pass-through entity and passed through to the partners or shareholders.

23300 Qualified Property

References (Repealed Sections) 17052.13(b)(2); 23612(b)(2)

EDAM 23310 Capitalized Requirement
EDAM 23320 Leased Property

Qualified property must be used exclusively in the Program Area and is defined as:

- Machinery and machinery parts used for:
    - Fabricating, processing, assembling, and manufacturing a product.
    - The production of renewable energy resources.
    - Air or water pollution control mechanisms.

Generally, qualified machinery parts include those parts that are necessary for the operation of the machinery (e.g., a conveyor belt).

Excluded parts are those used to complete a certain job. They are typically expensed to cost of good sold or general expense accounts (e.g., specialized drill blades and oil utilized for routine maintenance work).

23310 Capitalized Requirement

References (Repealed Sections) 17052.13(b)(2); 23612(b)(2)

Qualified property must be purchased and placed in service before the PA expires, is no longer binding or becomes inoperative. Qualified property cost(s) are costs chargeable to a capital account (subject to depreciation) of the qualified taxpayer. If costs are expensed, rather than capitalized, no credit is allowed.

23320 Leased Property

Taxpayers who acquire property by lease arrangement may qualify for the sales or use tax credit. Lease arrangements structured using a financial (conditional sales) contract generally will qualify the taxpayer to take the sales or use tax credit. For reference sources to determine if a lease qualifies as a purchase rather than a lease arrangement, refer to IRS Revenue Ruling 55-540, 1955-2 C.B. 39, and FTB Legal Ruling 94-2, March 23, 1994.

23400 Credit Computation – Asset Value Limitation

References (Repealed Sections) 17052.13(a); 17052.13(b)(2); 23612(a); 23612(b)(2)

EDAM 23410	Use Tax Paid on Qualified Property
EDAM 23420	Depreciable Basis
EDAM 23430	Business Income Activity Limitation
EDAM 23440	General Provisions - Income Apportionment
EDAM 23441	Property Factor – Income Apportionment
EDAM 23442	Payroll Factor – Income Apportionment
EDAM 23443	Sales Factor – Income Apportionment
EDAM 23444	Apportionment – Combined Groups
EDAM 23445	Apportioning for Personal Income Tax Taxpayers

The sales or use tax credit is equal to the amount of sales or use tax “paid or incurred” by the taxpayer in connection with the purchase and use of qualified property.

Example: Taxpayer spent $53,750 to purchase machinery used in the taxpayer's business within a Program Area. The sales tax paid on the purchase is $3,750. The sales tax credit is $3,750.

Individuals, estates or trusts, partnerships, and limited liability companies (LLCs) taxed as partnerships may claim a credit on the sales or use tax paid or incurred to purchase up to $1 million of qualified property. Corporations may claim a credit on the sales or use tax paid or incurred to purchase up to $20 million of qualified property. This limitation applies to each income or taxable year. (For S corporations and shareholders see EDAM 23500)

NOTE: Upon acquisition, if the taxpayer/purchaser was exempt from paying sales tax on the property under the California Revenue & Taxation Code (CR&TC), then the taxpayer/purchaser did not pay or incur sales tax in connection with the purchase of the property to the extent of the exemption. Thus, the taxpayer/purchaser is not allowed to take the sales or use tax credit for the exemption amount.

23410 Use Tax Paid on Qualified Property

References (Repealed Sections) 17052.13(c); 23612(c)

If a taxpayer, operating within a Program Area, purchases property out of state and pays or incurs a use tax, the credit is allowed only if qualified property of a comparable quality and price is not timely available for purchase in this state.

23420 Depreciable Basis

References (Repealed Sections) 17052.13(e); 23612(e)

Any taxpayer that elects to claim the sales or use tax credit, shall *not* increase the basis of the qualified property by the amount of the sales or use tax paid or incurred.

Example: Taxpayer spent $53,750 to purchase machinery used in the taxpayer's business within a Program Area. The sales tax included in the purchase price was $3,750. The basis of the property is $50,000 ($53,750 less $3,750 sales tax).

23430 Business Income Activity Limitation

References (Repealed Sections) 17052.13(d); 17052.13(f)(1); 23612(d); 23612(f)(1)

The amount of sales or use tax credit and hiring credit (see EDAM 22000) claimed, including any credit carryover from prior years, may not exceed the amount of tax on the taxpayer's Program Area business income in any year. The Program Area business income is that portion of *worldwide* business income that is apportioned to the Program Area. Non-business income or loss is not included in the calculation of business income from the Program Area. Each taxpayer claiming the credit must compute the Program Area business income and resulting tax.

Example: Corp. A operates exclusively within a Program Area. In order to determine the amount of sales or use tax credit allowable, the business income and the tax on that business income must be determined. Corp. A has the following items of income and expense:

Income from business operations	$30,000
Interest from investment which is unrelated to Corp. A's business operations	$2,000
Business expenses	(17,000)
Net Taxable Income	$15,000

Corp. A's income attributed to business operations is:

Income from business operations	$30,000
Business expenses	(17,000)
Net Business Income	$13,000

To determine the sales or use tax credit allowable, the net business income is multiplied by the current tax rate (the tax rate prior to 1997 was 9.3%).

Net Business Income	$13,000
x 9.3%	x 0.093
Tax associated with business income	$1,209

In this example, the taxpayer can offset the tax of $1,209 with the sales or use tax credit available (up to $1,209).

NOTE: "net tax"/"tax" and alternative minimum tax impose limitations on the allowable offset but were not considered a factor in this example.

23440 General Provisions - Income Apportionment

References (Repealed Sections) 17052.13(f); 23612(f)

If a business is located within and outside of a Program Area, or in more than one Program Area, the taxpayer must determine the portion of the total business income that is attributable to each Program Area.

- Business income is defined under the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA).
- Components of the factors are defined under the provisions of UDITPA.

For income or taxable years beginning on or after January 1, 1991, and ending on or before December 31, 1996 (1991 - 1995 years and 1996 calendar year taxpayers), business income is apportioned to the Program Area by multiplying the *worldwide* business income by a fraction, the numerator of which is the property factor plus the payroll factor, and the denominator of which is two (2).

For 1996 fiscal years, income or loss attributed to the Program Area is determined by multiplying *worldwide* business income or loss by a fraction, the numerator of which is the property factor, payroll factor, and sales factor (double weighted), the denominator of which is four (4).

For income or taxable years beginning before January 1, 1991, income or loss attributed to the Program Area is determined by multiplying *worldwide* business income or loss by a fraction, the numerator of which is the property factor, payroll factor, and sales factor, the denominator of which is three (3).

23441 Property Factor – Income Apportionment

References (Repealed Sections) 17052.13(f) 23612(f)

The property factor is a fraction. The numerator of the property factor is the average value of the real and tangible personal property owned or rented and used or available for use by the taxpayer *within the Program Area* during the income or taxable year. The denominator is the average value of all real and tangible personal property owned or rented and used or available for use during the income or taxable year *worldwide*.

Rented property is valued at eight (8) times the net annual rental rate. The net annual rental rate is the total rent paid for the property, less any subrental rates paid by subtenants.

23442 Payroll Factor – Income Apportionment

References (Repealed Sections) 17052.13(f) 23612(f)

The payroll factor is a fraction. The numerator of the payroll factor is the total compensation paid to employees working for the taxpayer *within the Program Area* during the income or taxable year. The denominator is the total compensation paid to employees working *worldwide* during the income or taxable year.

23443 Sales Factor – Income Apportionment

The sales factor is a fraction. The numerator of the sales factor is composed of the gross receipts as defined under the provisions of CR&TC §25134 - 25136, derived during the taxable or income year from transactions and activities occurring within the taxpayers trade or business in the Program Area. The denominator is composed of the gross receipts as defined under the provisions of CR&TC §25134 - 25136, derived during the taxable or income year from transactions and activities related to worldwide operations

General rules regarding the double weighting of the sales factor are applicable.

Example: For the income year ending 12/31/95, Corporation A operates within and outside a Program Area. Total business income of $13,000 needs to be apportioned to the Program Area. The following amounts apply to Corp. A's property and payroll:

Program Area Property	$40,000
WW Property	$100,000
Program Area Payroll	$5,000
WW Payroll	$10,000

Program Area Property/WW Property	=.40	
Program Area Payroll/WW Payroll	=.50	
	.90/2 = .45	Program Area Apportionment Factor

Business income	$13,000
Apportionment Factor	x 0.45
Program Area Business Income	$5,850
Current Tax Rate (Prior to 1997 – 9.3%)	x 0.093
Tax attributable to Program Area business income	$544

23444 Apportionment – Combined Groups

For members of a combined group, the credit limitation will be based on the combined groups worldwide business income (before CA apportionment). The numerator of the apportionment formula will be based on each Program Area taxpayer's separate Program Area payroll and property amounts (and sales as discussed in EDAM 23443) and the denominator will be based on the combined groups worldwide payroll and property amounts (and sales as discussed in EDAM 23443).

Example: For the income year ending 12/31/95, Parent Corporation A has two subsidiaries, B and C. Corporations A and B operate within a Program Area. The combined group operates within and outside California and apportions its income to California using Schedule R. The combined group's business income is $1,000,000.

Business income apportioned to the Program Area was determined as follows:

	A	B	C	Combined
Property Factor				
Program Area Property	$2,000,000	$1,000,000	$0	$3,000,000
Worldwide Property				$5,000,000
Apportionment %	40%	20%		60%
Payroll Factor				
Program Area Payroll	$2,000,000	$800,000	$0	$2,800,000
Worldwide Payroll				$4,000,000
Apportionment %	50%	20%		70%
Average Apport. % (Property + Payroll Factors)/2	45%	20%		65%
Business Income				$1,000,000
Program Area Income	$450,000	$200,000		$650,000

23445 Apportioning for Personal Income Tax Taxpayers

The following examples show the application of the apportioning rules to personal income tax taxpayers.

Example: Ray Smith is vice president of an S corporation that has two locations, one within a Program Area and one outside the Program Area. Eighty percent (80%) of the S corporation's business is attributable to the Program Area. (**NOTE**: This percentage was determined by the S corporation, using Worksheet V from the FTB 3805Z Business Booklet, at the time the S corporation return was prepared). Ray divides his time equally (50% & 50%) between the two offices of the S corporation.

Mary Smith (Ray's spouse) works for the S corporation at its office located within the Program Area.

Ray and Mary Smith have the following 1996 items of California income and expense:

Ray's salary from the S corp.	$100,000
Mary's salary from the S corp.	75,000
Interest on savings account	1,000
Dividends	3,000
Schedule K-1 (100S) from the S corp.	
Ordinary income	40,000
Program Area business expense deduction	(5,000)*
Ray's unreimbursed employee expenses from Schedule A	(2,000)

*The Program Area business expense deduction is a separately stated item on Schedule K-1 (100S).

The Smith's Program Area income is computed as follows:

Ray's Program Area salary ($100,000 x 50%)	$50,000
Mary's Program Area salary ($75,000 x 100%)	75,000
Pass-through ordinary income from the S-Corp. ($40,000 x 80%)	32,000
Program Area business expense deduction from the S-Corp.	(5,000)
Ray's unreimbursed employee business expenses (2,000 x 50%)	(1,000)
Total Program Area income	$151,000

Ray and Mary must compute the tax on the total Program Area income of $151,000 (as if it represents all of their income). Using the tax rate schedule for the filing status *married filing joint*; the 1996 tax on $151,000 is $10,938. The $10,938 is the first limitation on Program Area credits for the 1996 tax year. The second limitation on the credits is the *net tax* on all income.

NOTE: The standard deduction and personal or dependency exemptions are not included in the computation of Program Area income since they are not related to trade or business activities.

23500 S Corporation & Shareholder Credit Amounts

References 23803(a); (Repealed Section) 17052.13(b)(2) 23612(b)(2)

S corporations operating within a Program Area may claim a credit on the sales or use tax paid or incurred to purchase up to $20 million of qualified property. This limitation applies to each income year. The S corporation may only use one-third (1/3) of the credit to reduce the tax on the S corporation's Program Area income.

An S corporation's sales or use tax credit may reduce the Program Area tax at both the corporate and shareholder levels. One hundred percent (100%) of the Program Area credits are passed through to the S corporation shareholders. However, S corporation shareholders are only allowed to claim a credit on the sales or use tax paid or incurred on the purchase of up to $1 million of qualified property of the S corporation for each taxable year. The shareholders claim their pro-rata share of this credit as recomputed under the California personal income tax law (Part 10).

The sales or use tax credit is first computed for the S corporation using the actual qualified acquisition costs not to exceed $20 million. The amount of credit passing through to the shareholders is then computed using the actual qualified acquisition costs not to exceed $1 million. This credit based on the $1 million limitation is passed through to the shareholders based on their pro rata share. The Schedules K (100S) and K-1 (100S) must state the credit amounts allocable to the shareholders.

Example: Corp. Z, an S corporation, purchases $2 million of qualified property, and elects to take the Program Area sales or use tax credit. Corp. Z is allowed to claim a sales or use tax credit of $50,000 ($2,000,000 x 7.5% x 1/3 = $50,000). [Cost (not to exceed $20,000,000) x sales tax rate x 1/3 S corporation credit limitation]

The corporation's two shareholders allocate between them a sales or use tax credit of $75,000 ($1,000,000 x 7.5% = $75,000). [Cost (not to exceed $1,000,000) x sales tax rate]

NOTE: The State Board of Equalization in an unpublished (non-citable) decision, concluded that the $20 million limitation applied to the S-Corp and the $1 million limitation applied collectively to the S-Corp shareholders. *Appeal of Barry and Wendy Breslow, Cal. St. Bd. Of Equal., November 6, 2001.*

23600 Sales or Use Tax Credit and the Hiring Credit

References (Repealed Sections) 17052.13(f) 23612(f)

The amount of credit(s) allowed, in any income or taxable year, when a taxpayer is eligible to take both the sales or use tax credit and the hiring credit, is limited to the amount of tax imposed on the Program Area business income. Thus, the taxpayer must aggregate the credits and limit the total amount of credits to tax imposed on the Program Area business income.

23700 Credit Usage and Carryover

References (Repealed Sections) 17052.13(d) 17052.13(f) 23612(d) 23612(f)

EDAM 23710	Credit Will Not Reduce Certain Taxes
EDAM 23720	Depreciation
EDAM 23730	Credit Recapture

The portion of the credit that exceeds the "net tax"/"tax" for the income or taxable year, may be carried over and added to the credit, if any, in the following year. The credit may be carried over to succeeding years, until it is exhausted.

The aggregate amount of the Program Area credits, including any credit carryover from prior years, that may reduce the "net tax"/"tax" for the income or taxable year, shall not exceed the amount of tax imposed on the taxpayer's business income attributable to the Program Area, determined as if that income represented all of the income of the taxpayer.

Example: A taxpayer has $4,900 in Program Area credits (sales or use tax credit *and* hiring credit). Tax imposed on Program Area business income is $4,700 and the taxpayer's overall "net tax"/"tax" is $4,000. The maximum amount of credit is limited to the lesser of the tax on the Program Area business income, or the tax on the taxpayer's overall "net tax"/"tax".

Total Program Area credit	$4,900
Tax on Program Area income	$4,700
First limitation:	
Lesser of total credit or tax on Program Area income	$4,700
Second limitation:	
Lesser of tax on Program Area income or "*net tax*"/"*tax*"	$4,000
Maximum credit allowed:	
Lesser of *Program Area tax limitation* or "*net tax*"/"*tax*" *limitation*	$4,000
Total Program Area credit	$4,900
Maximum credit allowed	$4,000
Carryover	$ 900

If the taxpayer has any unused credits as of the date of the repeal of the Program Area tax incentives (income or taxable years beginning on or after January 1, 1997), the unused credits may continue to be carried forward until they are exhausted as Enterprise Zone incentives.

23710 Credit Will Not Reduce Certain Taxes

The Program Area sales or use tax credit cannot reduce the:

- Minimum franchise tax (corporations, limited partnerships, limited liability partnerships, LLCs, and S corporations);
- Built-in gains tax (S corporations);
- Excess net passive income tax (S corporation);
- Alternative minimum tax (corporations, exempt organizations, individuals and fiduciaries); or
- "Net tax" or "tax" below tentative minimum tax (TMT) before January 1, 1993

NOTE: For income or taxable years beginning on or after January 1, 1993, the Program Area hiring credit may reduce "net tax" / "tax" below TMT.

23720 Depreciation

References 18036 24916 (Repealed Section) 17052.13(e) 23612(e)

Taxpayers electing to utilize the sales or use tax credit are not entitled to increase the basis of the property for which sales or use tax was paid or incurred in connection with the purchase of the property.

Depreciation of the capitalized cost of the asset may be claimed using any method of depreciation allowable beginning in the year the asset is placed in service.

NOTE: If the business expense deduction is taken for the same property, depreciation will start with the income or taxable year following the year in which the property is placed in service. The depreciation is calculated on the remaining basis *after* reduction for the sales or use tax credit and business expense deduction amounts.

23730 Credit Recapture

There are no recapture provisions for the Program Area sales or use tax credit.

23800 Record Keeping Requirements

To support the sales or use tax credit claimed, the taxpayer must keep all records that document the purchase of the qualified property. This includes items such as purchase receipts and proof of payment. In addition, taxpayers should keep all records that identify or describe:

- The property purchased (such as serial numbers, etc.);
- The amount of sales or use tax paid or incurred upon purchase;
- The location where the property is used; and
- If purchased from a manufacturer located outside California, records to substantiate that property of comparable quality and price was not available for purchase in California.

Section 24000 PROGRAM AREA BUSINESS EXPENSE DEDUCTION

References (Repealed Sections) 17265(a); 24356.3(a)

Program Area designations expired as of January 1, 1997. Prior to this date, taxpayers had to be certified by the California Trade and Commerce Agency or TCA in order to be eligible to utilize the Program Area tax incentives. TCA could certify a taxpayer to take the hiring credit only or all five Program Area incentives. The type of certification is determined from the certification letter.

Certification was generally valid for three years. After three years, the taxpayer would have to be re-certified. De-certification could occur if a company failed to meet the requirements.

A taxpayer certified by TCA to claim all five Program Area tax incentives, and operating in a Program Area, could, for each income or taxable year, elect to treat 40% of the eligible cost of qualified property as a business expense rather than a capital expense.

The deduction was allowed for the income or taxable year in which the property was placed in service.

NOTE: For income and taxable years beginning on or after January 1, 1997, Program Areas were converted to Enterprise Zones (EZs) and are entitled to the benefits available to EZs. The following Program Area discussion relates to income and taxable years beginning prior to January 1, 1997.

24100 Geographic Boundaries and Designation Dates

For a listing of Program Area cities, see "Program Area Locations and Designation Dates " EDAM 1360. To verify an address, refer to EDAM 1300.

24200 Qualified Taxpayer

References (Repealed Sections) 17265(d)(4); 17265(e); 24356.3(d)

EDAM 24210	Pass-Through Entities
EDAM 24220	Estates and Trusts

For purposes of the Program Area business expense deduction, a *qualified taxpayer* is a person or entity (other than an estate or trust) that conducts a qualified trade or business within a Program Area.

24210 Pass-Through Entities

The determination of whether a taxpayer is a qualified taxpayer is made at the entity level. The term "pass-through entity" means any partnership or S corporation. The business expense deduction is allowed to the pass-through entity and passed through to the partners or shareholders.

24220 Estates and Trusts

References (Repealed Section) 17265(d)(4)

Estates and trusts are not allowed to take the business expense deduction.

24300 Qualified Property

References (Repealed Sections) 17265(a); 17265(d); 24356(a); 24356.3(c)

EDAM 24310 Leased Property
EDAM 24320 Property Not Qualified

Qualified property is property acquired by the taxpayer that is used exclusively within a Program Area and is defined as:

Machinery and machinery parts used for:

- Fabricating, processing, assembling, and manufacturing;
- The production of renewable energy resources.
- Air or water pollution control mechanisms;
- Property used as an integral part of a qualified business within a Program Area.

Qualified property must be purchased and placed in service *before* the date the Program Area designation expires, is no longer binding, or becomes inoperative.

24310 Leased Property

Taxpayers who acquire property by lease arrangement may be able to take the business expense deduction. The structure of the leasing arrangement itself is critical. Lease arrangements structured using a financial (conditional sales) contract generally will qualify the taxpayer to take the business expense deduction. For reference sources to determine if a lease qualifies as a purchase rather than a lease arrangement, refer to IRS Revenue Ruling 55-540, 1955-2 C.B. 39, and FTB Legal Ruling 94-2, March 23, 1994.

24320 Property Not Qualified

References (Repealed Sections) 17265(d); 24356.3(c)

The business expense deduction is not allowed if the property:

- Was transferred between members of an affiliated group;
- Was acquired as a gift or inherited;
- Was traded for other property;
- Was received from a personal or business relation as defined by IRC § 267, as modified by CR&TC §17265(d)(2)(A);
- Was received from a personal or business relation as defined by CR&TC §24427 through 24429, as modified by CR&TC §24356.3(c)(2)(A);
- Was received from a personal or business relation as defined by IRC §707(b); or
- Is described in IRC §179(d).

24400 Deduction Amount

References (Repealed Sections) 17265(g); 24356.3(f)

EDAM 24410	Partnerships
EDAM 24411	Personal Income Tax Taxpayers-Married Filing Separate
EDAM 24420	Basis reduction / Depreciation
EDAM 24430	Interaction with the Manufacturer's Investment Credit
EDAM 24440	Recapture

The maximum *deduction* the taxpayer may claim in any income or taxable year is determined by the number of years that have elapsed since the Program Area was designated, as follows:

Income or Taxable Years	Maximum Aggregate Cost	Maximum Deduction
Income or taxable year of designation and 1st year thereafter	$100,000	$40,000
2nd and 3rd income or taxable year thereafter	$75,000	$30,000
Each income or taxable year thereafter	$50,000	$20,000

No deduction is allowed for property purchased after the expiration of the Program Area designation.

24410 Partnerships

References (Repealed Section) 17265(d)(6)

In the case of a partnership, the percentage limitation (40%) of the aggregate cost of all qualified property shall apply at the partnership level and at the partner level.

24411 Personal Income Tax Taxpayers-Married Filing Separate

References (Repealed Section) 17265(b)

In the case of a husband and wife filing separate returns for a taxable year, the applicable deduction is equal to one-half (50%) of the otherwise allowable deduction.

24420 Basis reduction / Depreciation

The basis (cost for depreciation purposes) of the property is reduced by the amount allowed as a deduction. Depreciation of the cost of the property, less the amount deducted, is claimed using any method of depreciation normally allowed, beginning with the income or taxable year following the year in which the property is placed in service.

Taxpayers electing to take the business expense deduction cannot claim the additional first year depreciation allowed under IRC §179 / CR&TC §24356 for the same property.

24430 Interaction with the Manufacturer's Investment Credit

References 17053.49(b)(1)(C); 23649(b)(1)(C)

Taxpayers claiming the business expense deduction and the Manufacturers' Investment Credit (MIC) for the same property must reduce MIC qualified costs by the amount of the business expense deduction before computing the MIC. Taxpayers that elect to take the business expense deduction are not allowed to capitalize the expensed amount.

24440 Recapture

References (Repealed Sections) 17265(h); 24356.3(g): See also Cal. Code Regs. (CCR) § 17267.2-1(a); 24356.7-1

The business expense deduction is subject to recapture (added back to income) if, before the *close of the second income or taxable year after* the property is placed in service, the property ceases to be qualified property (sold, disposed of, or no longer used exclusively within the Program Area trade or business).

To recapture the amount deducted, add to the current year income, the amount previously deducted for that property.

Example: Corporation A purchases property on June 1, 1995 that qualifies it to take the Program Area business expense deduction. Corporation A's income year ends December 31 of each year. Corporation A disposes of the property August 5, 1997. The previous deduction is added to income in the 1997 tax year because the property was disposed of before the close of the second income or taxable year after the property was placed in service (12/31/1997). Corporation A will increase its basis in the asset by the recaptured amount effective January 1, 1997.

NOTE: The State Board of Equalization in an unpublished (uncitable) decision held that the statute requires the closure of two taxable years after the end of the taxable year in which the property is placed in service and the election to claim the deduction on the original return is made. *Appeal of Accurate Metal Fabricators, Inc., 32552, Cal. St. Bd. Of Equal., July 3, 2000.*

24500 Making the Election

References (Repealed Sections) 17265(a); 17265(c); 24356.3(a); 24356.3(b)

EDAM 24510 Members of an Affiliated Group

The taxpayer must make an election to treat the cost of qualified property as a business expense, on the original return filed for the income or taxable year the property is first placed in service. The election must specify the items to which the election applies and the portion of the cost taken into account for purposes of determining the deduction amount.

The election is not revocable, unless the taxpayer has obtained the consent of the Franchise Tax Board.

The taxpayer makes the election by filing:

- Form FTB 3805Z - Enterprise Zone/Program Area Deduction and Credit Summary.

24510 Members of an Affiliated Group

References (Repealed Sections) 24356.3(c)(5); 24356.3(c)(6)

For purposes of electing the business expense deduction, all members of an affiliated group are treated as one taxpayer. The deduction is properly apportioned among the members of the affiliated group.

An affiliated group is defined in IRC §1504 as modified by the California Revenue & Taxation Code, to replace "*at least 80%*" with "*more than 50%*" each place it appears in IRC §1504(a).

24600 Creating a Net Operating Loss

Unlike IRC §179, there is *no* statutory prohibition on the amount of business expense deduction amount that may create a net operating loss.

24700 Alternative Minimum Tax

References 17062; 23457

The business expense deduction is *not* listed as a tax preference item.

24800 Checklist to Determine Eligibility for the Business Expense Deduction

Checklist Items	Yes	No
Is the business qualified? • Is a trade or business conducted within a Program Area? See the *Taxpayer Defined* section.		
Is the property qualified? • Qualified property is tangible personal property that is subject to the allowance for depreciation. See the Qualified Property section. • Is the property used exclusively within the boundaries of a Program Area?		
Is the correct deduction amount claimed? • The limitation differs based upon the taxable or income year since the area designation. See *Deduction Amount* section. • Verify purchase on invoices or receipts. • Verify the date the property is placed in service.		
Was a timely election made? • Election made on original return? • Form FTB 3805Z – Enterprise Zone/Program Area Deduction and Credit Summary, or a separate statement attached to the return?		
Was the property acquired through a valid transaction? • See the *Property Not Qualified* section.		
Was correct depreciation claimed? • Basis must be reduced by the amount of the business expense deduction before depreciation is computed. • IRC §179 expense or additional first year depreciation may not be claimed on qualified property for which the business expense deduction is claimed. • A depreciation deduction on qualified property is not allowed in the same year the business expense deduction is claimed.		
Is the deduction subject to recapture? • Was the property sold, disposed of or no longer used by the taxpayer in the Program Area, before the close of the second income or taxable year after the property was placed in service? • Check the current location of the qualified property. • Check the sale or disposal date of qualified property.		

24900 Record Keeping Requirements

To support the business expense deduction claimed, the taxpayer must keep all records that document the purchase of the qualified property. This includes items such as purchase receipts and proof of payment. In addition, taxpayers should keep all records that identify or describe:

- The property purchased (such as serial numbers, etc.); and
- The location where the property is used

Section 25000 PROGRAM AREA NET OPERATING LOSS

References 17276.1(a); 24416.1(a); Repealed Sections 17276.2(a); 24416.2(a)

To claim Program Area incentives, taxpayers had to be certified by the California Trade and Commerce Agency or TCA. TCA could certify a taxpayer to take the hiring credit only or all five Program Area incentives. The type of certification can be determined from the certification letter. A taxpayer certified by TCA to claim all five Program Area tax incentives, and operating in a Program Area, may claim the Program Area net operating loss (NOL) deduction.

Certification was generally valid for three years. After three years, the taxpayer would have to be re-certified. De-certification could occur if a company failed to meet the requirements.

Taxpayers are required to annually report their income and expenses. Possible fluctuations in income and expenses may create substantial profits in one year, while losses in another. In years where expenses exceed income, an NOL occurs.

A qualified taxpayer (certified) engaged in a trade or business within the designated Program Area may elect to carry forward 100% of its NOL for a period of 15 years.

A Program Area NOL cannot be generated until the first taxable or income year beginning on or after the area has been officially designated as a Program Area.

NOTE: For income and taxable years beginning on or after January 1, 1997, Program Areas were converted to Enterprise Zones (EZs) and are entitled to the benefits available to EZs. The following Program Area discussion relates to income and taxable years beginning prior to January 1, 1997. Relevant CR&TC § are:

- 17276 - 17276.3
- 24416 - 24416.3

25100 Geographic Boundaries and Designation Dates

For a listing of Program Areas and designation dates, refer to EDAM 1360. To verify an address, refer to EDAM 1300.

25200 Qualified Taxpayer

References (Repealed Sections) 17276.2(a); 24416.2(a)

EDAM 25210 Pass-Through Entities
EDAM 25211 S Corporations

For purposes of the Program Area NOL deduction, a qualified taxpayer includes a person or entity that is engaged in a trade or business within a Program Area.

Qualified taxpayers doing business in an area that was previously not a qualified area, but later designated as qualified, are allowed to utilize the special tax incentives for the taxable or income year beginning on or after the date the area receives designation as a Program Area.

25210 Pass-Through Entities

In the case of any "pass-through entity", the determination of whether a taxpayer is a qualified taxpayer is made at the entity level.

25211 S Corporations

References 17087.5; 17087.6; 17851; 23800; 23802(d)(1)-(2); 24271

For qualified taxpayers electing S corporation status *after* the designation of the Program Area, the qualified NOL attributed to the C corporation years cannot offset S corporation net income. The income and loss that will flow through to a shareholder, beneficiary, partner, or member, retains the same characteristics as it had with the pass-through entity.

The election (EDAM 25300) to claim an NOL is made by the entity and each investor on their respective returns. The election by the entity to utilize the Program Area NOL does not extend to, or bind the investor to utilizing the Program Area NOL. Further, the investor may utilize the Program Area
NOL if the entity utilized the general NOL provisions, or had no NOL. Each taxpayer must determine if they in fact have an NOL, and then decide whether to utilize the general or Program Area NOL.

25300 Making the Election

References 17276.1(a)-(b); 24416.1(a) & (c); Repealed Sections 17276.2(e)-(g); 24416.2(e)-(g)

Qualified taxpayers must make an election to claim the Program Area NOL. The election must be timely filed with the original return, and be for the income or taxable year in which the NOL is incurred. The election is irrevocable.

If the taxpayer is eligible to qualify for an NOL under more than one section (operation in more than one economic development area, new small business etc.), the taxpayer must choose which section to elect. Except for the loss incurred under the subdivision elected, taxpayers are prohibited from carrying over any other type of NOL from the same tax year.

Failure to elect to compute the NOL under CR&TC §17276.1 or 24416.1 will cause the NOL to be subject to the limitations and restrictions under CR&TC §17276 or 24416 (general NOL).

A taxpayer makes the election by filing Form FTB 3805Z – Enterprise Zone/ Program Area Deduction and Credit Summary.

In addition, the form FTB 3805Z must be filed for each year in which the NOL deduction is taken.

25400 Program Area NOL Computation - General Provisions

References 17276.1(a); 24416.1(a); Repealed Sections 17276.2(a)(2)(A); 24416.2(a)(2)(A)

EDAM 25410 Program Area NOL Limited by General NOL

A Program Area NOL is the loss attributable to the qualified taxpayer's business activities within a Program Area, prior to the Program Area expiration date. Program Area NOLs are determined under IRC §172, as modified by the following CR&TC §:

- 17276.1
- 17276.2
- 24416.1
- 24416.2

25410 Program Area NOL Limited by General NOL

References 17276; 24416

The Program Area NOL as computed under EDAM 25500 is compared to the NOL computed under the general NOL provisions of CR&TC §17276 / 24416, *prior to the 50% reduction*. The Program Area NOL carryover is limited to the lesser of the Program Area NOL or the general NOL (prior to the 50% reduction). **NOTE**: If the Program Area NOL is limited by the general NOL amount, (prior to the 50% reduction), the amount can still be characterized as a Program Area NOL and allowed to be carried over at 100% for 15 years. An election must be made to characterize the NOL as a Program Area NOL.

Example: Corp. B incurred the following loss:

Income from business operations	160,000
Interest from investment which is unrelated to Corp. B's business operations	15,000
Expenses of business operations	(189,000)
Net loss	**($14,000)**

To determine the NOL carryover attributed to the Program Area business operations, do the following:

1. Determine NOL per CR&TC §24416 (prior to 50% reduction);
2. Determine NOL per CR&TC § 24416.2 (remove non-business items)

The NOL carryover is limited to the lesser of item 1 or item 2 above.

1. CR&TC §24416 "general" NOL - prior to 50% reduction
   Net loss of Corp. B ($14,000)
2. CR&TC §24416.2 Program Area NOL - exclude non-business income/loss

Income from operations	$160,000
Expenses of operations	(189,000)
Net loss of Corp. B (Program Area)	($29,000)

Assume Corp. B operates entirely within the Program Area. Corp. B is allowed to carry over the lesser of the "general" NOL, or the Program Area NOL; in this case $14,000.

Assume Corp. B conducts 40% of its total business operations in the Program Area as computed under EDAM 25500. Because Corp. B only has 40% of its business operation in the Program Area, the $29,000 business loss must be apportioned before comparing it to the "general" NOL. In this example, the Program Area loss is $11,600 ($29,000 x

40%). Corp. B is allowed to carry over the lesser of the "general" NOL, or the Program Area NOL; in this case, $11,600.

25500 Program Area NOL - Loss Attributed to Business Activity

References (Repealed Sections) 17276.2(a)(2)(A); 17276.2(a)(2)(A)(i); 24416.2(a)(2)(A); 24416.2(a)(2)(A)(i)

EDAM 25510	Property Factor – Loss Apportionment
EDAM 25520	Payroll Factor – Loss Apportionment
EDAM 25530	Sales Factor – Loss Apportionment
EDAM 25540	Apportionment – Combined Groups
EDAM 25550	Apportioning for Personal Income Tax Taxpayers

A Program Area NOL is the loss attributable to the qualified taxpayer's business activities within the Program Area prior to the Program Area expiration date. Non-business income and/or loss are excluded from the calculation of the Program Area NOL.

If a business is located within and outside of a Program Area, the taxpayer must determine the portion of the total business loss that is attributable to the Program Area.

- Business loss is defined under the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA).
- Components of the factors are defined under the provisions of UDITPA.

For income or taxable years beginning after January 1, 1996 and before January 1, 1997 (1996 fiscal year taxpayers), business loss is apportioned to the Program Area by use of a four-factor apportionment formula. Worldwide business loss is multiplied by a fraction, the numerator of which is the property factor, payroll factor, and the double-weighted sales factor. The denominator is four (4).

For income or taxable years beginning on or after January 1, 1991, and ending on or before December 31, 1996 (1991 - 1995 year taxpayers and 1996 calendar year taxpayers), business loss is apportioned to the Program Area by multiplying the worldwide business loss by a fraction, the numerator of which is the property factor plus the payroll factor, and the denominator of which is two (2).

For income or taxable years beginning before January 1, 1991, business loss attributed to a Program Area is determined by multiplying worldwide business loss by a fraction, the numerator of which is the property factor, payroll factor, and sales factor, the denominator of which is three (3).

25510 Property Factor – Loss Apportionment

The property factor is a fraction.

- The numerator of the property factor is the average value of the real and tangible personal property owned or rented and used or available for use by the taxpayer *within the Program Area* during the income or taxable year.
- The denominator is the average value of all real and tangible personal property owned or rented and used or available for use during the income or taxable year *worldwide.*

Rented property is valued at eight (8) times the net annual rental rate. The net annual rental rate is the total rent paid for the property, less any subrental rates paid by subtenants.

25520 Payroll Factor – Loss Apportionment

The payroll factor is a fraction.

- The numerator of the payroll factor is the total compensation paid to the taxpayer's employees working *within the Program Area* during the income or taxable year.
- The denominator is the total compensation paid to employees working *worldwide* during the income or taxable year.

25530 Sales Factor – Loss Apportionment

The sales factor is a fraction.

- The numerator of the sales factor is composed of the gross receipts as defined under the provisions of CR&TC §25134 - 25136, derived during the taxable or income year from transactions and activities occurring within the taxpayers trade or business in the Program Area.
- The denominator is composed of the gross receipts as defined under the provisions of CR&TC §25134 - 25136, derived during the taxable or income year from transactions and activities related to worldwide operations

General rules regarding the double weighting of the sales factor are applicable.

Example - Two-factor apportionment: For the income year ending 12/31/95, Corp. A operates within and outside a Program Area. Corp. A's business loss of $13,000 needs to be apportioned to the Program Area. The following amounts apply to Corp. A's property and payroll:

Program Area Property	$40,000
Worldwide (WW) Property	$100,000
Program Area Payroll	$5,000
WW Payroll	$10,000

Program Area Property/WW Property	=.40	
Program Area Payroll/WW Payroll	=.50	
	.90/2 = .45	Program Area Apportionment Factor

Business loss	$(13,000)
Apportionment Factor	x 0.45
Program Area NOL	$(5,850)

NOTE: The four-factor apportionment formula is as follows:

Zone income = (property, payroll, & sales factors/ 4) x worldwide business income.

Property factor = zone property/worldwide property
Payroll factor = zone payroll/worldwide payroll
Sales Factor = zone sales/worldwide sales x 2

25540 Apportionment – Combined Groups

For members of a combined group, the Program Area NOL calculation will be based on the combined groups worldwide business loss (before CA apportionment). The numerator of the apportionment formula will be based on each Program Area taxpayer's separate Program Area payroll and property amounts (and sales as discussed in EDAM 25530), and the denominator will be based on the combined groups worldwide payroll and property amounts (and sales as discussed in EDAM 25530).

Example: For the income year ending 12/31/95, Parent Corporation A has two subsidiaries, B and C. Corporations A and B operate within a Program Area. The combined group operates within and outside California and apportions its income or loss to California using Schedule R. The combined group's business loss is $1,000,000.

Business loss apportioned to the Program Area was determined as follows:

	A	**B**	**C**	**Combined**
Property Factor				
Program Area Property	$2,000,000	$1,000,000	$0	$3,000,000
Worldwide Property				$5,000,000
Apportionment %	40%	20%		60%
Payroll Factor				
Program Area Payroll	$2,000,000	$800,000	$0	$2,800,000
Worldwide Payroll				$4,000,000
Apportionment %	50%	20%		70%
Average Apport. % (Property + Payroll Factors)/2	45%	20%		65%
Business Loss				$(1,000,000)
Program Area NOL	$(450,000)	$(200,000)		$(650,000)

25550 Apportioning for Personal Income Tax Taxpayers

The following examples show the application of the apportioning rules to personal income tax taxpayers.

Example: Ray Smith is vice president of an S corporation that has two locations, one within a Program Area and one outside the Program Area. Eighty percent (80%) of the S corporation's business is attributable to the Program Area. (**NOTE**: This percentage was determined by the S corporation, using Worksheet V from the FTB 3805Z Business Booklet, at the time the S corporation return was prepared). Ray divides his time equally (50% & 50%) between the two offices of the S corporation.

Mary Smith (Ray's spouse) works for the S corporation at its office located in the Program Area.

Ray and Mary Smith have the following 1996 items of California income and expense:

Ray's salary from the S corp.	$100,000
Mary's salary from the S corp.	75,000
Interest on savings account	1,000
Dividends	3,000
Schedule K-1 (100S) from the S corp.	
Ordinary Loss	200,000
Program Area	
Business expense deduction	(5,000)*
Ray's unreimbursed employee expenses from Schedule A	(2,000)

*The Program Area business expense deduction is a separately stated item on Schedule K-1 (100S).

The Smith's Program Area loss is computed as follows:

Ray's Program Area salary ($100,000 x 50%)	$50,000
Mary's Program Area salary ($75,000 x 100%)	75,000
Pass-through ordinary loss from the S-Corp. ($200,000 x 80%)	(160,000)
Program Area business expense deduction from the S-Corp.	(5,000)
Ray's unreimbursed employee business expenses (2,000 x 50%)	(1,000)
Total Program Area loss	$(41,000)

NOTE: The standard deduction and personal or dependency exemptions are not included in the computation of Program Area NOL since they are not related to trade or business activities.

25600 Carryover / Carryback

References 17276.1(a); 24416.1(a); Repealed Sections 17276.2(a)(1); 24416.2(a)(1)

For each income or taxable year, a qualified taxpayer, engaged in a trade or business within a designated Program Area, may elect to carryover 100% of its NOL. No NOL carrybacks are allowed.

The NOLs may be carried over to each of the 15 income or taxable years following the year of loss, or until exhausted, whichever occurs first. If an NOL carryover remained at the time the Program Areas were repealed and converted to Enterprise Zones (effective 1/1/97), the carryover amount is now classified as an Enterprise Zone NOL carryover. If an Enterprise Zone NOL carryover remains after the Enterprise Zone designation has expired, the Enterprise Zone is deemed to remain in existence for purposes of computing the Enterprise Zone income limitation, and for purposes of allowing the Enterprise Zone NOL deduction.

25700 NOL Deduction - General Provisions

References (Repealed Sections) 17276.2(a)(2)(B); 24416.2(a)(2)(B)

EDAM 25710	Business Income Activity Limitation
EDAM 25711	Property Factor – Income Apportionment
EDAM 25712	Payroll Factor – Income Apportionment
EDAM 25713	Sales Factor – Income Apportionment
EDAM 25714	Apportionment – Combined Groups
EDAM 25715	Apportioning for Personal Income Tax Taxpayers

The Program Area NOL carryover can only offset business income attributable to operations of the taxpayer within the designated Program Area. Non-business income/loss is excluded from the calculation of business income from the qualified area.

In the event a Program Area NOL carryover is allowable for any taxable or income year after the Program Area designation has expired, the Program Area is deemed to remain in existence for the purpose of computing the business income limitation and allowing an NOL deduction.

25710 Business Income Activity Limitation

References (Repealed Sections) 17276.2(a)(2)(A); 17276.2(a)(2)(B)(i); 24416.2(a)(2)(A); 24416.2(a)(2)(B)(i)

If a business is located within and outside of a Program Area, the taxpayer must determine the portion of the total business income that is attributable to the Program Area.

- Business income is defined under the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA).
- Components of the factors are defined under the provisions of UDITPA.

For income or taxable years beginning after January 1, 1996 and before January 1, 1997 (1996 fiscal year taxpayers), business income is apportioned to the Program Area by use of a four-factor apportionment formula. Worldwide business income is multiplied by a fraction, the numerator of which is the property factor, payroll factor, and the double-weighted sales factor. The denominator is four (4).

For income or taxable years beginning on or after January 1, 1991, and ending on or before December 31, 1996 (1991- 1995 year taxpayers and 1996 calendar year taxpayers), business income is apportioned to the Program Area by multiplying the worldwide business income by a fraction, the numerator of which is the property factor plus the payroll factor, and the denominator of which is two (2).

For income or taxable years beginning before January 1, 1991, business income attributed to a Program Area is determined by multiplying worldwide business income by a fraction, the numerator of which is the property factor, payroll factor, and sales factor, the denominator of which is three (3).

25711 Property Factor – Income Apportionment

The property factor is a fraction.

- The numerator of the property factor is the average value of the real and tangible personal property owned or rented and used or available for use by the taxpayer *within the Program Area* during the income or taxable year.
- The denominator is the average value of all real and tangible personal property owned or rented and used or available for use during the income or taxable year *worldwide*.

Rented property is valued at eight (8) times the net annual rental rate. The net annual rental rate is the total rent paid for the property, less any subrental rates paid by subtenants.

25712 Payroll Factor – Income Apportionment

The payroll factor is a fraction.

- The numerator of the payroll factor is the total compensation paid to the taxpayer's employees working *within the Program Area* during the income or taxable year.
- The denominator is the total compensation paid to employees working *worldwide* during the income or taxable year.

25713 Sales Factor – Income Apportionment

The sales factor is a fraction.

- The numerator of the sales factor is composed of the gross receipts as defined under the provisions of CR&TC §25134 - 25136, derived during the taxable or income year from transactions and activities occurring within the taxpayers trade or business in the Program Area.
- The denominator is composed of the gross receipts as defined under the provisions of CR&TC §25134 - 25136, derived during the taxable or income year from transactions and activities related to worldwide operations

General rules regarding the double weighting of the sales factor are applicable.

Example - Two-factor apportionment: For the income year ending 12/31/95, Corp. A operates within and outside a Program Area. Corp. A's business income of $13,000 needs to be apportioned to the Program Area. The following amounts apply to Corp. A's property and payroll:

Program Area Property	$40,000
Worldwide (WW) Property	$100,000
Program Area Payroll	$5,000
WW Payroll	$10,000

Program Area Property/WW Property	=.40	
Program Area Payroll/WW Payroll	=.50	
	.90/2 = .45	Program Area Apportionment Factor

Business income	$13,000
Apportionment Factor	x 0.45
Program Area income	$5,850

NOTE: The four-factor apportionment formula is as follows:

Zone income = (property, payroll, & sales factors/ 4) x worldwide business income.

Property factor = zone property/worldwide property
Payroll factor = zone payroll/worldwide payroll
Sales Factor = zone sales/worldwide sales x 2

25714 Apportionment – Combined Groups

For members of a combined group, the Program Area business income calculation will be based on the combined groups worldwide business income (before CA apportionment). The numerator of the apportionment formula will be based on each Program Area taxpayer's separate Program Area payroll and property amounts (and sales as discussed in EDAM 25713), and the denominator will be based on the combined groups worldwide payroll and property amounts (and sales as discussed in EDAM 25713).

Example: For the income year ending 12/31/95, Parent Corporation A has two subsidiaries, B and C. Corporations A and B operate within a Program Area. The combined group operates within and outside California and apportions its income or loss to California using Schedule R. The combined group's business income is $1,000,000.

Business income apportioned to the Program Area was determined as follows:

	A	**B**	**C**	**Combined**
<u>Property Factor</u>				
Program Area Property	$2,000,000	$1,000,000	$0	$3,000,000
Worldwide Property				$5,000,000
Apportionment %	40%	20%		60%
Payroll Factor				
Program Area Payroll	$2,000,000	$800,000	$0	$2,800,000
Worldwide Payroll				$4,000,000
Apportionment %	50%	20%		70%
Average Apport. % (Property + Payroll Factors)/2	45%	20%		65%
Business Income				$(1,000,000)
Program Area Business Income	$(450,000)	$(200,000)		$(650,000)

25715 Apportioning for Personal Income Tax Taxpayers

The following examples show the application of the apportioning rules to personal income tax taxpayers.

Example: Ray Smith is vice president of an S corporation that has two locations, one within a Program Area and one outside the Program Area. Eighty percent (80%) of the S corporation's business is attributable to the Program Area. (**NOTE**: This percentage was determined by the S corporation, using Worksheet V from the FTB 3805Z Business Booklet, at the time the S corporation return was prepared). Ray divides his time equally (50% & 50%) between the two offices of the S corporation.

Mary Smith (Ray's spouse) works for the S corporation at its office located in the Program Area.

Ray and Mary Smith have the following 1996 items of California income and expense:

Ray's salary from the S corp.	$100,000
Mary's salary from the S corp.	75,000
Interest on savings account	1,000
Dividends	3,000
Schedule K-1 (100S) from the S corp.	
Ordinary Loss	40,000
Program Area business expense deduction	(5,000)*
Ray's unreimbursed employee expenses from Schedule A	(2,000)

*The Program Area business expense deduction is a separately stated item on Schedule K-1 (100S).

The Smith's Program Area income is computed as follows:

Ray's Program Area salary ($100,000 x 50%)	$50,000
Mary's Program Area salary ($75,000 x 100%)	75,000
Pass-through ordinary income from the S-Corp. $40,000 x 80%	32,000
Program Area business expense deduction from the S-Corp.	(5,000)
Ray's unreimbursed employee business expenses (2,000 x 50%)	(1,000)
Total Program Area income	$151,000

NOTE: The standard deduction and personal or dependency exemptions are not included in the computation of the Program Area NOL since they are not related to trade or business activities.

25800 NOL Suspensions

References 17276.3(c); 24416.3(c)

For taxable years beginning in 2002 and 2003, California has suspended the Net Operating Loss (NOL) carryover deduction. Taxpayers may continue to carryover an NOL during the suspension period. The carryover period for suspended losses is extended by two years for losses incurred before January 1, 2002 and by one year for losses incurred after January 1, 2002 and before January 1, 2003. The deduction for disaster losses is not affected by the NOL suspension rules.

NOLs incurred by qualified Program Area taxpayers are *not* suspended for taxable or income years beginning in 1991 and 1992.

25900 Alternative Minimum Tax

References 17062; 23456

Taxpayers claiming a Program Area NOL deduction must also determine their NOL for alternative minimum tax purposes.

Section 26000 PROGRAM AREA NET INTEREST DEDUCTION

References (Repealed Sections) 17231; 24384

Repealed California Revenue & Taxation Code (CR&TC) Sections 17231 and 24384 provided for the deduction of net interest income from loans made to a trade or business located solely within a Program Area. The net interest deduction is for interest payments received after the designation of the Program Area and before taxable or income years beginning before January 1, 1997.

For income and taxable years beginning on or after January 1, 1997, Program Areas were converted to Enterprise Zones (EZs) and are entitled to the benefits available to EZs (see CR&TC §17235 and 24384.5). Loans previously qualifying a creditor for the Program Area net interest deduction convert to the EZ net interest deduction.

The following Program Area discussion relates to income and taxable years beginning prior to January 1, 1997.

26100 Geographic Boundaries and Designation Dates

For a listing of Program Areas and designation dates, refer to EDAM 1360. To verify an address, refer to EDAM 1300.

26200 Qualified Taxpayer

References (Repealed Sections) 17231(a); 24384(a)

EDAM 26210 Pass-Through Entities

For purposes of the program area net interest deduction, a qualified taxpayer includes a person or entity (creditor) that loans funds on or after the designation of the Program Area, to a qualified business/debtor and receives interest payments thereon. The loan advanced to the qualified business/debtor must also meet the requirements as discussed in EDAM 26300.

The creditor does not have to be located in the Program Area to take advantage of the net interest deduction. Only the debtor needs to operate in the Program Area.

26210 Pass-Through Entities

In the case of any "pass-through entity", the determination of whether a taxpayer is a qualified taxpayer is made at the entity level.

26300 Qualified Debt

References (Repealed Sections) 17231(b); 24384(b)

EDAM 26310 Security/Collateral

To claim the net interest deduction for creditors, the following requirements must be met at the time the indebtedness is incurred:

- The trade or business (*qualified business/debtor*) to which the loan is made, is located solely within a Program Area;
- The indebtedness is incurred solely in connection with activity within the Program Area; and
- The creditor has no equity or other ownership interest in the debtor.

  NOTE: Repealed CR&TC §17231(b) & 243845(b) require that the creditor have no equity or other ownership interest in the debtor at the time the loan is made. However, the CR&TC does not provide for any limitation after the loan is made. For example, assume that two years after the qualified loan is made the debtor contacts the creditor to renegotiate the loan terms due to the debtor's poor financial condition. The creditor agrees to take an equity interest in the debtor in exchange for reducing the amount due from the debtor. Net interest received from the remaining portion of the qualified loan is still deductible.

To claim the net interest deduction for creditors, the following requirements must be met annually:

- The qualified business/debtor that the loan was made to and interest payments are received from must be conducting business in the program area.

  Example: Two years after the qualified loan is funded, the qualified business/debtor moves their operations entirely outside of the Program Area geographic boundaries. The net interest deduction is no longer allowed because the trade or business is not located within the designated program area.

26310 Security/Collateral

The statute does not require that the security or collateral for the loan be located in the Program Area. For example, a sole proprietor can use its personal residence as collateral for the Program Area business loan and the creditor would still be allowed the net interest deduction assuming all other qualifications are met.

26400 Definition of "Qualified Business/Debtor"

The definition of a *qualified business* in Section 7082 of the Government Code requires inquiry at the entity level. The business activity of the entity (entirely or a portion thereof as relevant) must be conducted within a Program Area.

26500 Definition of a "Trade or Business"

Black's Law Dictionary defines *trade or business* as follows:

"Any business or professional activity conducted by a taxpayer, the objective of which is to earn a profit. The general test for determining whether a person is engaged in "trade or business" so as to be entitled to deduct expenses as trade or business expenses under the Internal Revenue Code is whether the taxpayer's primary purpose and intention in engaging in the activity are to make a profit."

26600 Definition of "Located Solely Within"

References (Repealed Sections) 17231(b)(1); 24384(b)(1)

In order to claim the net interest deduction, the loan must be made to a qualified business *located solely within* a Program Area. Generally, one looks to the presence of tangible property in order to determine the place, site, or limits of a business. Intangible property by definition cannot be located by reference to physical presence. The presence of all of the qualified trade or business' payroll and tangible property within a Program Area would be a strong indication that they meet the test. The fact that sales are delivered by common carrier outside of the Program Area should not cause the borrower to fail the "*located solely within*" requirement.

26700 Net Interest Deduction – Computation

For purposes of determining the net interest deduction, *net interest* is gross interest received less related interest expense (cost of funds) and any other directly related expenses.

26710 Gross Interest

Substantial differences may exist between *tax* and *book* accounting methods. Consequently, the amount of gross interest income included in the computation of net interest is determined using the creditor's tax accounting method (i.e., the gross interest income included in the computation of net interest corresponds to the gross interest income included in the determination of taxable income). Gross interest income should not include items that are *not* in the nature of interest.

Interest is defined as an amount paid for the use or forbearance of money.

Gross interest is determined by referencing the loan contract. A contract between a creditor and a qualified trade or business may include all of the following:

- A stated rate of interest;
- Points;
- Commitment fees (fees for entering into an agreement that obligates the lender to make funds available for an agreed period at a stated rate of interest - see Rev. Rul. 70-540)*;
- Service fees (fee charged for processing a loan); and
- Escrow interest.

Analysis of each of the above items is necessary to determine which are in the nature of interest. For example, commitment fees and service fees are not included in gross interest for purposes of determining the net interest deduction as they are fees earned when establishing the loan and are not monies paid for the use of the loaned funds.

Points are a charge by the lender, in addition to the stated rate of interest, to reflect the actual cost of borrowing money. Thus, points as here described, are for the use or forbearance of money and are considered interest. Escrow interest is interest from the date the loan is funded until 30 days before the borrower's first loan payment. Original issue discount (OID) is another form of interest. Stated interest, points, escrow interest, and OID are all items that may be included in gross interest for purposes of determining the net interest deduction.

***NOTE:** Revenue Ruling 70-540, 1970-2 CB 101 discusses the character of commitment fees from the lender's point of view. The commitment fee is a charge for agreeing to make funds available rather than for the use or forbearance of money, and therefore, is not interest. Other revenue rulings discuss commitment fees from the point of view of the borrower. To the extent of any discussion concerning the treatment of points by the lender, Rev. Rul. 70-540 was made obsolete by Rev. Proc. 94-29, 1994-1 CB 616; this does not affect its relevance in regards to commitment fees.

26720 Cost of Funds

A reasonable amount of interest expense is assigned to the interest income. One method of determining a reasonable cost of funds is the following formula:

$$\frac{\text{Interest Expense}}{\text{Funding Sources}} = \text{Cost of Funds}$$

Funding sources are equal to average liabilities plus owners' equity less average non-interest earning assets.

The ratio from the above formula is multiplied by the average loan principal outstanding for the year. All amounts are on a tax basis.

For example, assume the following is from the tax return of a financial institution:

Average liabilities and owners' equity	$53,000,000,000	
LESS: Average non-interest earning assets	7,000,000,000	
Funding Sources	$46,000,000,000	
Total Interest Expense	$ 1,500,000,000	
Funding Sources	$46,000,000,00	= 3.26%

Assume that an average principal amount of $10 million was outstanding during the year for loans made to businesses within a Program Area. A reasonable amount of interest expense to assign to the loans is $326,000 ($10 million times 3.26%).

Taxpayers may also use an independent cost of funds index such as the prime index rate or the London Interbank Offered Rate (LIBOR), which is the rate banks use to place Eurodollars with one another in London. If an independent index is used, that index must approximate the taxpayer's cost of funds.

The annual report of many banks or savings and loan associations provides the average cost of funds. The net interest margin (the difference between interest income and interest expense) is usually of interest to shareholders and other users of the annual report. The net interest margin should be similar to that used for the calculation of the net interest deduction.

26730 Other Related Expenses

"Net interest" is interest received less the cost of funds and direct expenses incurred in earning such interest. An example of a direct expense is commission paid to a loan representative. Expenses that are not directly attributable to the loan in question are not subtracted for purposes of determining the net interest deduction.

All reasonably identifiable direct costs applicable to acquiring or making a loan are capitalized and written off over the life of the loan. The amortization method should reflect the nature of the loan. It is reasonable to use straight line or principal reduction methods of amortization (see Rev. Proc. 94-29 for application of the principal reduction method).

26740 Non-Bank & Non-Financial Lenders

Non-financial corporations and individuals usually do not have all of the various income and expense items referred to previously.

Generally, gross interest of non-bank or non-financial creditors is the interest income as stated in the loan. For example, an individual creditor will generally avoid escrow interest by establishing the monthly due date of the loan as the day of the month the loan was funded, or the day escrow closed, whereas mortgages carried by a commercial lender generally have a common due date, i.e., the beginning of the month.

Related expenses, such as the cost of funds, are determined in order to compute the deduction of net interest income. Non-bank or non-financial lenders who make loans to qualified businesses located solely within the program area may incur investment interest expense related to such loans. The interest tracing rules under Treas. Reg. 1.163-8T are appropriate for determining related interest expense for these taxpayers.

26800 Repeal of Program Areas

For income and taxable years beginning on or after January 1, 1997, Program Areas were converted to Enterprise Zones (EZs) and are entitled to the benefits available to EZs (see CR&TC §17235 and 24384.5). Loans previously qualifying a creditor for the Program Area net interest deduction convert to the EZ net interest deduction.

26900 Record Keeping

The qualified taxpayer/creditor should maintain records on each loan (loan agreements) for which a deduction of net interest is taken, that identifies or describes:

- The debtor,
- The debtor's location (at the time of indebtedness and annually),
- The debtor's mailing address,
- The purpose/use of the loan,
- The stated interest,
- Other items included in gross interest,
- Any direct expenses associated with the loan, and
- Any property securing the loan.