



State of California
Franchise Tax Board

Research & Development Credit:

Frequently Asked Questions

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1. What is California's Research & Development (R&D) Credit?

The California R&D Credit reduces income or franchise tax. You qualify for the credit if you paid or incurred qualified research expenses while conducting qualified research in California. You receive 15 percent of the excess of current year research expenditures over a computed base amount (minimum of 50 percent of current year research expenses). You claim the credit on the return for the taxable year you incurred the qualified expenses.

2. How do you claim the California R&D Credit?

You claim the California R&D Credit on FTB Form 3523, *Research Credit*, for the year you paid or incurred qualified research and development expenses in California.

3. Does California conform to federal R&D Credit provisions?

California law generally conforms to the federal research credit as enacted under the Small Business Job Protection Act of 1996. However, California does make some modifications. The more common modifications are:

1. The definition of "qualified organization" includes hospitals run by public universities and certain cancer centers.
2. "Basic research" and "qualified research" must be conducted in California to qualify.
3. For taxable years beginning on or after 1/1/2000, the credit is 15 percent of qualified research expenses for all taxpayers. In addition, corporations (other than S Corporations, personal holding companies, and service organizations) may be eligible for the "basic research" credit, which is equal to 24 percent of the excess of basic research payments paid or incurred during the year over the base period amount. The basic research rate is 24 percent.
4. California conformed to the Alternative Incremental Credit, except for some differences in the rates and the fact that California requires a separate election (from that of federal). For taxable years beginning on or after 1/1/2000, the percentages for the Alternative Incremental Credit are 1.49 percent, 1.98 percent, and 2.48 percent.
5. California has not conformed to the 2006 federal amendments to IRC §41. Thus, the Alternative Simplified Credit is not available.
6. The credit cannot be carried back.
7. California does not conform to the federal definition of gross receipts.
8. The termination dates provided under federal law do not apply. Currently, there is no California termination date for this credit.

4. What is "qualified research" for California's R&D Credit?

Research activity is considered "qualified research" if it meets **all** of the following four requirements of Internal Revenue Code (IRC) §41(d)(1):

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

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

5. What research activities do not qualify for California's R&D Credit?

The following research activities are specifically excluded by statute:

1. Research undertaken outside California.
2. Research conducted in the social sciences, arts, or humanities.
3. Ordinary testing or inspection of materials or products for quality control.
4. Market and consumer research.
5. Research relating to style, taste, cosmetic, or seasonal design.
6. Advertising and promotional expenses.
7. Management studies and efficiency surveys.
8. Computer software for internal use of the taxpayer, unless it meets additional tests.
9. Research to locate and evaluate mineral deposits, including oil and gas.
10. Acquisition and improvement of land and of certain depreciable or depletable property used in research (including the annual depreciation deduction).
11. Research conducted after the beginning of commercial production.
12. Research related to adaptation of an existing business component.

13. Research related to duplication of an existing business component from a physical inspection, plans, blueprints, detailed specifications, etc....
14. Funded research – Any research funded by any grant, contract, or otherwise by another person (or governmental entity).

6. What are "qualified research expenses" (QRE) for California's R&D Credit?

Qualified research expenses generally include wages, supplies, and contract research costs.

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

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

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

7. What are "basic research payments" for California's R&D Credit?

The term "basic research payment" means any amount paid in cash during the taxable year by a corporation (other than S corporations, personal holding companies, and service organizations) to a qualified organization for basic research, but only if such payment is made pursuant to a written agreement and the basic research is to be performed by the qualified organization in California. Qualified organizations include educational institutions, certain scientific research organizations, and certain grant organizations. For California, "basic research" includes any basic or applied research including scientific inquiry or original investigation for the advancement of scientific or engineering knowledge or the improved effectiveness of commercial products, but not if the improvements relate to style, taste, cosmetic, or seasonal design factors. For additional information, see the instructions for FTB Form 3523, *Research Credit*, regarding the taxable year the basic research payments may be claimed.

8. How are "gross receipts" defined for California purposes?

California gross receipts include receipts minus returns and allowances from the sale of real, tangible, or intangible property held for sale to customers in the ordinary course of the taxpayer's trade or business delivered or shipped to a purchaser within California, regardless of free on board shipping point or other condition of sale. This includes sales to the U.S. government, which could be identified as delivered in California. Excluded receipts are items such as California "throwback" sales for apportionment purposes, as well as, receipts from services, rents, operating leases and interest. In addition, royalties and license payments are generally excluded from the definition of gross receipts for research credit purposes.

Qualified California gross receipts include any property sale defined above (delivered to a California customer) that has been excluded for apportionment purposes because of the application of Public Law 86-272 or any other provision.

This California definition of gross receipts applies to both the average annual gross receipts for the prior four years and the base years (1984-1988). For aggregation purposes, the "gross receipts" figures used in the base amount calculations (the "average annual gross receipts" and the "aggregate gross receipts" of the fixed-base percentage) should reflect those from the entire "controlled group" (even when only one corporation has research expenses). Using the "gross receipts" of the entire controlled group reflects an accurate comparison of the research expenditures to the business as a whole.

9. What are the aggregation rules?

All members of a "controlled group" are treated as a single taxpayer for purposes of the research credit. You must aggregate all components comprising the R&D Credit calculation. The total or "group" R&D Credit is assigned to the members of the controlled group based upon their proportionate share of their stand-alone credit over the total all computed stand-alone credits for the group. If the "group" credit exceeds the sum of the stand-alone credits, the excess "group" credit is allocated based on each member's qualified research expenses divided by the sum of all

members' qualified research expenses. The computed stand-alone credits are only used to determine the proportionate share of group credit to be allocated to a particular member. You compute the stand-alone credit utilizing the best method available (i.e. regular, AIRC, etc.); in other words, you compute to yield the largest credit possible as if you were not part of the controlled group.

10. How are a "controlled group" and "controlled trades & businesses" defined for California's R&D Credit?

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

In the case of a corporation that is part of a parent/subsidiary group, a controlling interest is defined as more than 50 percent of the combined voting power of all classes of stock or more than 50 percent of the total value of shares of all classes of stock. The terms "interest" and "stock" do not include treasury stock or nonvoting stock that is limited and preferred regarding dividends. In the case of partnerships, a controlling interest is defined as more than 50 percent of a profit or capital interest, and in the case of an estate or trust, a controlling interest is defined as more than 50 percent of an actuarial interest.

In the case of a corporation that is part of a brother/sister group, a controlling interest is defined as more than 80 percent of the combined voting power of all classes of stock or more than 80 percent of the total value of shares of all classes of stock held by the same five or fewer persons. The terms "interest" and "stock" do not include treasury stock or nonvoting stock that is limited and preferred regarding dividends. In the case of partnerships, a controlling interest is defined as more than 80 percent of a profit or capital interest held by same five or fewer individuals and in the case of an estate or trust, a controlling interest is defined as more than 80 percent of an actuarial interest held by same five or fewer individuals. The two groups differ in percentages and a brother/sister group considers the ownership control of multiple individuals within the member organizations.

11. Is the "controlled group" for R&D Credit aggregation purposes the same as a "unitary group" for combined reporting purposes?

No. The "controlled group" is not necessarily restricted to the entities included in the combined report and may include non-unitary affiliates. It may also include multiple combined reporting groups.

12. Is the "controlled group" restricted to entities either currently or historically conducting research?

No. The "controlled group" is generally comprised of all entities commonly owned by a single interest more than 50 percent in the case of a parent/subsidiary group or commonly owned by the same five or fewer owners more than 80 percent in the case of a brother/sister group. Controlled group members that are currently performing California.

13. What is a start-up company for California R&D Credit purposes?

A start-up company is one that had both qualified California research expenses and gross receipts either:

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

The fixed-base percentage for a start-up company is 3 percent for each of the company's first five taxable years beginning on or after January 1, 1994, that the company has a qualified research expense. There is a ten-year phase-in period leading up to a permanent fixed base percentage calculation based on five contiguous years of experience during the 6th through the 10th year. A progressively increasing rate applies during the period between the 6th and 10th year, see IRC §41(c)(3)(B)(ii) for further information.

14. Is there a documentation requirement?

Yes. California taxpayers benefit from the R&D Credit as a valuable tax incentive. A taxpayer must maintain records in sufficiently usable form and detail to substantiate that the expenditures claimed qualify for the credit. Presenting detailed and well-maintained records to FTB upon request will help expedite the audit of your R&D Credit.

Treasury Decision 9104 did eliminate the "unique" documentation requirements to define qualified research under Treas. Reg. §1.41-4(d). However, taxpayers are obligated to follow the broader language of the current Treas. Reg. §1.41-4(d), the requirements of IRC §6001, and established case law related to record keeping (Revenue and Taxation Code Section 19504; *New Colonial Ice Co v. Helvering*, 292 US 435 [78 L.Ed. 1348](1934)).

15. What are the specific documentation requirements for the California R&D Credit?

With few exceptions, the State of California conforms to the federal research credit computation. A taxpayer must maintain records in sufficiently usable form and detail to substantiate that the expenditures claimed are eligible for the credit (Current Treas. Reg. §n 1.41-4(d)). Treas. Reg. §1.6001-1 requires the taxpayer to clearly establish full compliance with all of the relevant statutory and regulatory requirements. The regulation requires taxpayers to keep permanent books and records sufficient to establish the amount of gross income, deductions, credits, or other matters for as long as the contents thereof may become material in the administration of any internal revenue law, or in California's case the revenue and taxation law. Simply put, taxpayers must retain all relevant documentation for as long a period as may be required to address a material item: in this case the research credit and its related expenditures and components. Failure to maintain records in accordance with these rules is a basis for disallowing the credit.

16. Are we required to provide contemporaneous support?

It is also clear from the above regulation and case law that contemporaneous documentation and support are generally required. Contemporaneous means the documentation or support should be from the time period of the underlying transactions, services, or activities. While the state can provide taxpayers with some degree of flexibility in substantiating their credit, this flexibility does not relieve the obligation to keep and provide a record of their qualified research and research expenditures. Extrapolations based upon data from a later period or estimated percentages developed years later are not contemporaneous and have no probative value. For example, if a taxpayer contemplates filing a research credit claim as an existing research entity, the taxpayer will need to establish and provide contemporaneous documentation of the qualified research expenditures and gross receipts performed during 1984 through 1988.

17. Can we use estimates?

The State of California is not required to accept estimates of qualified research expenses to verify the actual amount if documentation exists or should exist. Taxpayers are required to keep records substantiating the amount of any reported, claimed, or affirmatively raised deductions or credits (Appeal of Don A. Cookston, 83-SBE-048 (January 3, 1983)). Failure to maintain records in accordance with the above requirements is a basis for disallowing the credit.

However, the courts may allow the use of an estimation method, but only where the taxpayer can prove contemporaneous records do not exist and then only as long as the following two conditions are satisfied:

1. The taxpayer must establish that it engaged in qualified research activities as defined in IRC §41(d), and
2. The failure to maintain a proper system to capture relevant information cannot be an "inexactitude of their own making." (Cohan v. Commissioner, 39 F.2d 540, 544 (2d Cir. 1930.))

Accordingly, taxpayers must have factual support for every assumption underlying their estimates to meet their burden of proof. A valid estimation requires some indirect basis at a minimum.

18. What is sufficient documentation?

You should maintain all documents necessary to support your credit and its components. We generally look for contemporaneous documentation of a typical business nature supporting the item under examination. "A typical business nature" refers to customary documentation prepared in relation to a given transaction or process.

Each section of IRC §41 requires different forms or types of support. For instance, the documentation necessary to support qualified **services** (IRC §41(b) wages, supplies, contract research) is different than that required to support qualified **research** (IRC §41(d) qualified research defined). These documentation types are, in turn, different from the documentation necessary to support the other computational elements of the credit (IRC §41(c) fixed base percentage and average annual gross receipts).

The taxpayer's situation determines what documentation is necessary. Taxpayers often refer to documents by different titles, and research operations vary in the degree to which their transactions and processes are documented. In most credit audits, documentation is being maintained for purposes other than the credit. For example, highly regulated industries (such as biopharmaceutical, defense, engineering, medical, or high technology industries) are usually required to maintain detailed documentation of their research and experimentation processes for regulatory requirements from a consumer product safety process, FDA approval process, patent application process, etc. In addition, documentation you compile and utilize for internal control, budget, or project analysis, and human resource purposes can be used to support the credit.

You may support the gross receipts component with shipping and sales support records. Apportioning taxpayers may be able to utilize their tax apportionment work papers. However, sales by destination schedules should not include the application of Public Law 86-272, i.e. regardless of the sale's origination point.

19. What documents will FTB typically rely upon?

Documents we typically rely on to support various research credit elements include:

- Materials explaining research activities, including brochures, pamphlets, press releases, and other similar documents.
- Submissions to management, the board of directors, review committees or other similar groups regarding research projects, activities, expenditures, and the research credit.
- Documents prepared by, or on behalf of, internal audit, including quarterly and annual reports that refer in any manner to research activities.
- Minutes, notes, or other similar recordings from budget, board of directors, managerial, or other similar meetings concerning research activities.
- Project authorizations, budgets, or work orders that initiate a research project.
- The internal authorization policies for approving a research project.
- Project summaries and/or progress reports and project meeting minutes.
- Field and lab verification data/summary data.
- Research credit studies conducted by outside consultants.
- Papers, treatises, patents and their supporting work papers, letters, scientific articles acknowledging the work, supply invoices, or other published documents about the taxpayer's research.
- Human resource documents including self-appraisals, annual reviews, and time reports.
- Travel and entertainment reimbursement forms.
- Email.
- Original signed contracts (including all modifications), letter agreements, memoranda of understanding, or similar documents for research performed by, or on behalf of, a third party.
- Federal and state tax returns (including other state tax returns). This would also include apportionment work papers to prepare the various state tax returns.
- The general ledger.

In addition to the documents listed above, credible oral testimony by individuals with personal knowledge of the issues may be helpful in supplementing a taxpayer's contemporaneous documentation. However, oral or written testimony by itself is not a substitute for contemporaneous documentation. We may need to conduct interviews to provide documentation opportunities, or to confirm, clarify, or refute other documentary or testimonial evidence. We may disallow the credit for corporations who fail to maintain records in accordance with these rules. While there does exist a degree of flexibility in substantiating the credit, it neither relieves nor eliminates a taxpayer's obligation to keep and provide a record of their qualified research and expenditures.

20. How should we document our research and expenditures when our company is small, organizationally flat, and not in a highly regulated industry?

Again, you should maintain all documents necessary to support your credit and its components. It may be true that your circumstances may not provide documentation in a typical or structured format. The Franchise Tax Board recognizes this fact and tries to work with you to identify documentation opportunities. However, research is a coordinated activity. There is discussion of planning, methodology, goals, testing, etc.

Some examples of alternative or less formal documentation that may help us verify your credit and its components include, but are not limited to, e-mails, calendars, notes, correspondences, etc. Again, taxpayers providing detailed and well-maintained records to FTB upon request will expedite audits of the R&D Credit.

21. How does the inclusion of a partnership affect the R&D Credit?

If a partnership meets the ownership inclusion test then we treat the partnership as a group member. The partnership receives its appropriate share of group credit under the aggregation rules. The partnership's allocated group credit passes to its partners based on their proportionate distributive share of the research expense items. You report the allocated credit amount on line 40 of FTB Form 3523, *Research Credit*.

If the partnership is not part of a parent/subsidiary or brother/sister group, the partnership's California research expenses and gross receipts will not be included in any controlled group computation.

22. How does the acquisition or disposition of a business entity affect the California R&D Credit computation?

Acquisition or dispositions of trades or businesses should be identified and verified (from the base period to the current year) to confirm that they are properly reflected in the computation. The determination year's QREs and the base period years' QREs are determined based upon the application of the law in effect for the determination (current) year under examination. Consistency between these periods is required; see IRC §41(c)(5) for more information.

23. Does the R&D Credit have to be added back into income as a California state adjustment?

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

Taxpayers may avoid the reduction of their research and development expenses by electing to take a reduced credit in accordance with IRC §280C(c)(3). This election reduces the research credit by the amount of tax savings created by the double tax benefit. The maximum tax rates are used for this computation. On FTB Form 3523 *Research Credit*, corporations multiply their research credit by 91.16 percent (.9116), individuals and estates or trusts multiply their research credit by 90.7 percent (.907), and S corporations multiply their research credit by 98.5 percent (.985) to arrive at the reduced credit amount. This irrevocable election must be made on the original California return filed on or before the due date for filing the return, including extensions. The election cannot be made on an amended return.

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

24. Do we need FTB permission to change our election reducing our research and development expenses by the amount of credit, rather than applying the applicable reduced credit percentage to the credit?

No permission is needed on an original filed return. Taxpayers may annually choose between the election options. The reduction to R&D expenses or "add back" is required any time the annual IRC §280C(c) reduced credit option is not elected. In addition, taxpayers can make different elections for federal and state purposes.

25. Can the credit reduce alternative minimum tax?

No. The credit cannot reduce the alternative minimum tax; however, the credit may reduce the regular tax below the tentative minimum tax. See Schedule P (Forms 100, 100W, 540, 540NR, or 541) for more information. Any research and development credit that is not used to offset the qualified taxpayer's income or franchise tax must be carried over to future years.

26. Can we amend a prior year return to claim a qualified R&D Credit?

Yes, as long as the applicable statute of limitations is open (generally four years from the original due date of the return, or one year from the date of the overpayment, whichever period expires later). However, the 280(C) election to reduce the credit cannot be made on an amended return.

27. Is California's R&D Credit a refundable credit?

No. Any R&D Credit that is not used to offset the qualified taxpayer's income or franchise tax must be carried over to future years.