

Legal Division Guidance 2011-06-01

(Federal Conformity – Research and Development Tax Credit – Gross Receipts – Service Business)

Q: Does California fully conform to the IRC section 41(c)(6) definition of "gross receipts" with respect to California service receipts?

A: No. RTC section 23609(h)(3) provides that IRC section 41(c)(6), which defines "gross receipts" for federal purposes, shall not apply. Instead, California specifically modifies the IRC section 41(c)(6) definition of "gross receipts" to include sales of property within California, and excludes receipts that are not "sales of property." Items that are excluded include throwback sales, as well as *receipts from services*, rents, operating leases and interest.

Q: Can a purely service company with no "gross receipts" within the meaning of RTC section 23609(h)(3) claim the California R&D credit?

A: No. A taxpayer that has no California gross receipts, because it has only service receipts, is not allowed to claim the California R&D credit. To claim the R&D credit, at some point in time, a taxpayer must have had both qualified research expenses and gross receipts in the same year. This is also true with respect to the "start-up" method of IRC section 41(c)(3)(B), as this method too requires a taxpayer to have both gross receipts and qualified research expenses in the same year. (IRC section 41(c)(3)(B)(i). *See also* Treas. Reg. §§ 1.41-6(b), & 1.41-6(e), ex. (4) & (5).)

Moreover, a taxpayer must establish that it correctly calculated its California base amount and fixed-base percentage under IRC section 41(c) and RTC section 23609. A taxpayer with no California gross receipts cannot make such a showing. The fixed-base percentage calculation requires division of base year "qualified research expenses" by base year "average annual gross receipts," and mathematically, a number cannot be divided by zero.