

TITLE 18. FRANCHISE TAX BOARD

As required by Government Code section 11346.4, this is notice that a public hearing has been scheduled at 10:00 a.m., October 29, 2002, at the State Board of Equalization hearing room, 5901 Green Valley Circle, second floor, Culver City, California, to consider the adoption of California Code of Regulations, title 18, proposed sections 17053.36-0 through 17053.36-9 and 23636-0 through 23646-9 (Joint Strike Fighter Wage Credit), and proposed sections 17053.37-0 through 17053.37-11 and 23637-0 through 23637-11 (Joint Strike Fighter Property Credit). Although the proposed regulations concern separate tax credits (a wage credit and a property credit), these proposed regulations are being noticed together under this notice because they both were enacted as part of the same legislative scheme and both concern the same activities surrounding the construction of the Joint Strike Fighter aircraft.

Proposed California Code of Regulations, title 18, sections 17053.36-0 through 17053.36-9, and 23636-0 through 23646-9, clarify and interpret numerous provisions of the Joint Strike Fighter Wage Credit statutes, Revenue and Taxation Code sections 17053.36 and 23636, by providing definitions of statutory words and phrases and by providing numerous hypothetical examples designed to illustrate the statutory and regulatory rules. Proposed California Code of Regulations, title 18, sections 17053.37-0 through 17053.37-11, and 23637-0 through 23637-11, clarify and interpret numerous provisions of the Joint Strike Fighter Property Credit statutes, Revenue and Taxation Code sections 17053.37 and 23637, by providing definitions of statutory words and phrases and by providing numerous hypothetical examples designed to illustrate the statutory and regulatory rules.

An employee of the Franchise Tax Board will conduct the hearing, and a report will be submitted to the three-member Franchise Tax Board for its consideration, along with a recommendation as to whether the three-member Board should hold a hearing on the proposed regulatory action. Government Code section 15702, subdivision (b), provides for consideration by the three-member Franchise Tax Board of any proposed regulatory action, if any person makes such a request in writing. If a written request is received, the three-member Franchise Tax Board will consider the proposed regulatory action prior to adoption.

Interested persons are invited to present comments, written or oral, concerning the proposed regulatory action. It is requested, but not required, that persons who make oral comments at the hearing also submit a written copy of their comments at the hearing.

WRITTEN COMMENT PERIOD

Written comments will be accepted until 5:00 p.m., October 29, 2002. All relevant matters presented will be considered before the proposed regulatory action is taken. Comments should be submitted to the agency officer named below.

AUTHORITY AND REFERENCE

Revenue and Taxation Code section 19503 authorizes the Franchise Tax Board to prescribe regulations necessary for the enforcement of Part 10 (commencing with section 17001), Part 10.2

(commencing with section 18401), Part 10.7 (commencing with section 21001) and Part 11 (commencing with section 23001). Moreover, Revenue and Taxation Code sections 17053.37, subdivision (c)(3), and 23637, subdivision (c)(3), specifically authorize the Franchise Tax Board to prescribe any regulations necessary to carry out the purposes of the Joint Strike Fighter Property Credit contained in those sections. The proposed regulatory action provides guidance, gives illustrative examples, interprets, implements, and makes specific Revenue and Taxation Code sections 17053.36, 17053.37, 23636, and 23637.

INFORMATIVE DIGEST/ POLICY STATEMENT OVERVIEW

AB 2797 (Stats. 1998, Ch. 322) added entirely new sections to both the Personal Income Tax Law, Revenue and Taxation Code sections 17053.36 and 17053.37, and the Corporation Tax Law, Revenue and Taxation Code sections 23636 and 23637.

Revenue and Taxation Code sections 17053.36 and 23636 (Joint Strike Fighter Wage Credit) generally provide a credit equal to specified percentages of qualified wages, beginning with 50% of qualified wages in the 2001 taxable year and decreasing each subsequent year to 10% of qualified wages in the 2005 taxable year. Qualified wages must be paid to a qualified employee whose services are performed in California and are at least 90% directly related to the contract or subcontract to manufacture a product for ultimate use in a Joint Strike Fighter aircraft.

Revenue and Taxation Code sections 17053.37 and 23637 (Joint Strike Fighter Property Credit) generally provide a ten percent (10%) income or franchise tax credit to qualified taxpayers for the construction, reconstruction or acquisition of qualified property that is placed in service in California. Qualified property must be placed in service in California and used primarily to produce a product for ultimate use in a Joint Strike Fighter aircraft.

Revenue and Taxation sections 17053.36, 17053.37, 23636 and 23637 are new California tax incentive provisions designed to encourage the creation of manufacturing jobs in California in connection with the development of the Joint Strike Fighter aircraft. The Joint Strike Fighter Wage Credit and Joint Strike Fighter Property Credit are available to taxpayers under an initial contract or subcontract to manufacture a product designed for ultimate use in a Joint Strike Fighter aircraft. There is no federal law directly comparable to the Joint Strike Fighter Wage and Property credits. These credits are companion credits and where similar, the same words and phrases have been incorporated into both regulations. In addition, the Joint Strike Fighter Property Credit is substantially similar to the California Manufacturers' Investment Credit, Revenue and Taxation Code sections 17053.49 and 23649, and the regulations thereunder. The comparable concepts and relevant definitions contained in the Joint Strike Fighter Property Credit regulation are the same as those contained in the Manufacturers' Investment Credit regulations.

Proposed California Code of Regulations, title 18, sections 17053.36-0 through 17053.36-9, 23636-0 through 23636-9, 17053.37-0 through 17053.37-11, and 23637-0 through 23637-11, are needed because of the relative complexity of Revenue and Taxation Code sections 17053.36, 23636, 17053.37 and 23637, and the use of terms of art, many of which are not defined in the statutes. Moreover, in order to claim the credit, taxpayers must reduce the amount of any bid to

construct all or a portion of the Joint Strike Fighter by the amount of the Joint Strike Fighter Wage Credit and Joint Strike Fighter Property Credit allowable. By defining and explaining these terms of art, and providing examples to illustrate these definitions and explanations, these regulations provide interpretations to assist taxpayers in determining eligibility for the Joint Strike Fighter Wage Credit and Joint Strike Fighter Property Credit and the proper amount of any reduction to be applied to a Joint Strike Fighter bid. In drafting these regulations, the Franchise Tax Board looked to Revenue and Taxation Code sections 17053.36, 23636, 17053.37 and 23637, the legislative history, the Manufacturers' Investment Tax Credit statutes and regulations, and existing federal and state tax provisions.

In addition, on May 14, 2001, the Franchise Tax Board posted to its website a copy of an informal discussion draft of proposed California Code of Regulations, title 18, sections 17053.36-0 through 17053.36-9, 23636-0 through 23636-9, 17053.37-0 through 17053.37-11, and 23637-0 through 23637-11, and issued FTB Notice 2001-4, directing the public to the website and inviting comments on the draft proposed regulations. Pursuant to that notice, a symposium was held on July 13, 2001, where interested parties discussed the informal proposed draft language with Franchise Tax Board staff. Based on these comments, Franchise Tax Board staff revised the proposed regulations to address concerns raised by the public.

1. Joint Strike Fighter Wage Credit

Proposed California Code of Regulations, title 18, sections 17053.36-0 through 17053.36-9

These proposed regulations are organized as a series of related regulations that are separated by subject matter area. Where appropriate or required, specific cross-reference information has been provided in the text of the applicable regulations. Moreover, due to the complexity and length of both the statute and these regulations, Proposed California Code of Regulations, title 18, section 17053.36-0, contains a non-substantive, non-binding table of contents designed to assist readers in locating specific subject matter areas in proposed California Code of Regulations, title 18, sections 17053.36-1 through 17053.36-9.

Proposed California Code of Regulations, title 18, section 17053.36-1, provides rules regarding the amount of the Joint Strike Fighter Wage Credit, the years in which the Joint Strike Fighter Wage Credit may be claimed, cross-reference information and general reference information regarding proposed California Code of Regulations, title 18, sections 17053.36-1 through 17053.36-9. In addition, this proposed regulation provides a summary of the distinction between the Joint Strike Fighter Wage Credit and the Joint Strike Fighter Property Credit contained in Revenue and Taxation Code sections 17053.37 and 23637.

Proposed California Code of Regulations, title 18, section 17053.36-2, provides general definitions for certain words and phrases used in Revenue and Taxation Code section 17053.36 and proposed California Code of Regulations, title 18, sections 17053.36-1 through 17053.36-9. Specifically, definitions of "Joint Strike Fighter," "initial contract or subcontract," "Joint Strike Fighter Program," "manufactured," and "product for ultimate use in a Joint Strike Fighter" are provided. Where appropriate or specifically required by the statutory language of Revenue and

Taxation Code section 17053.36, some of these definitions are further clarified by reference to existing California or federal law.

Proposed California Code of Regulations, title 18, section 17053.36-3, provides rules and examples for determining who is a qualified taxpayer for purposes of the Joint Strike Fighter Wage Credit. Since the definition of a qualified taxpayer for the Joint Strike Fighter Wage Credit in Revenue and Taxation Code section 17053.36 is identical with the definition of a qualified taxpayer for the Joint Strike Fighter Property Credit in Revenue and Taxation Code section 17053.37, this proposed regulation applies and incorporates by reference proposed California Code of Regulations, title 18, section 17053.37-3, and the term "qualified taxpayer" in that proposed regulation shall have the same effect in this proposed regulation.

Proposed California Code of Regulations, title 18, section 17053.36-4, provides rules and examples for determining qualified wages for purposes of the Joint Strike Fighter Wage Credit. Specifically provided are rules regarding the requirement that qualified wages are limited to that portion of wages that constitute direct labor costs as that term is used in Internal Revenue Code section 263A. Also included are rules regarding the term employee and the fact that wages for engineering, design and testing activities specifically qualify for the Joint Strike Fighter Wage Credit. Finally, the amount of qualified wages is provided in this proposed regulation.

Proposed California Code of Regulations, title 18, section 17053.36-5, provides rules and examples for determining who is a qualified employee for purposes of the Joint Strike Fighter Wage Credit. Specifically, this proposed regulation defines the term "employee" as an employee described in Unemployment Insurance Code sections 13004, 13004.1 and 13004.5. This proposed regulation also explains that a qualified employee must perform services in this state and those services must be at least 90% directly related to the qualified taxpayer's contract or subcontract to manufacture property for ultimate use in a Joint Strike Fighter. This proposed regulation provides guidance on computing the \$10,000 per employee wage limitation. Finally, this proposed regulation defines the term "directly related" for determining whether an employee's services qualify for the Joint Strike Fighter Wage Credit.

Proposed California Code of Regulations, title 18, section 17053.36-6, provides rules applicable to Joint Strike Fighter contract bidding. This proposed regulation provides that no Joint Strike Fighter Wage Credit shall be allowed unless the credit is reflected within the bid that forms the basis for the taxpayer's contract or subcontract to manufacture property for ultimate use in a Joint Strike Fighter. Specifically, this proposed regulation defines the term "bid," "reflected within the bid," and "credit allowable." This proposed regulation also contains examples of bids within which the credit is reflected. Finally, this proposed regulation provides that in the case of a pass-through entity, the amount of the credit reflected on the bid is the amount of the credit that the entity expects to pass-through to the partners or shareholders.

Proposed California Code of Regulations, title 18, section 17053.36-7, provides rules for determining the length of the carryforward period for the Joint Strike Fighter Wage Credit. In addition, this proposed regulation provides rules for carryforwards for pass-through entities and carryforwards permitted after the sunset date of Revenue and Taxation Code section 17053.36.

Proposed California Code of Regulations, title 18, section 17053.36-8, provides rules illustrating which books and records should be maintained to substantiate any Joint Strike Fighter Wage Credit claimed. Specifically, this proposed regulation discusses the general burden of proof and identifies the books and records that should be maintained.

Proposed California Code of Regulations, title 18, section 17053.36-9, provides miscellaneous rules applicable to the Joint Strike Fighter Wage Credit. Specifically provided are the effective dates of the Joint Strike Fighter Wage Credit, and the interaction of the Joint Strike Fighter Wage Credit with the Enterprise Zone Hiring Credit. The rules and cross-references in this proposed regulation have been drawn from other places in the Revenue and Taxation Code that may not otherwise be readily apparent to taxpayers who wish to claim the Joint Strike Fighter Wage Credit.

Proposed California Code of Regulations, title 18, sections 23636-0 through 23636-9

These proposed regulations are organized as a series of related regulations that are separated by subject matter area. Where appropriate or required, specific cross-reference information has been provided in the text of the applicable proposed regulations. Moreover, due to the complexity and length of both the statute and these proposed regulations, proposed California Code of Regulations, title 18, section 23636-0, contains a non-substantive, non-binding table of contents designed to assist readers in locating specific subject matter areas in proposed California Code of Regulations, title 18, sections 23636-1 through 23636-9.

Proposed California Code of Regulations, title 18, section 23636-1, provides rules regarding the amount of the Joint Strike Fighter Wage Credit, the years in which the Joint Strike Fighter Wage Credit may be claimed, cross-reference information and general reference information regarding proposed California Code of Regulations, title 18, sections 23636-1 through 23636-9. In addition, this proposed regulation provides a summary of the distinction between the Joint Strike Fighter Wage Credit and the Joint Strike Fighter Property Credit contained in Revenue and Taxation Code sections 17053.37 and 23637.

Proposed California Code of Regulations, title 18, section 23636-2, provides general definitions for certain words and phrases used in Revenue and Taxation Code section 23636 and proposed California Code of Regulations, title 18, sections 23636-1 through 23636-9. Specifically, definitions of "Joint Strike Fighter," "initial contract or subcontract," "Joint Strike Fighter Program," "manufactured," and "product for ultimate use in a Joint Strike Fighter" are provided. Where appropriate or specifically required by the statutory language of Revenue and Taxation Code section 23636, some of these definitions are further clarified by reference to existing California or federal law.

Proposed California Code of Regulations, title 18, section 23636-3, provides rules and examples for determining who is a qualified taxpayer for purposes of the Joint Strike Fighter Wage Credit. Since the definition of a qualified taxpayer for the Joint Strike Fighter Wage Credit in Revenue and Taxation Code section 23636 is identical with the definition of a qualified taxpayer for the Joint Strike Fighter Property Credit in Revenue and Taxation Code section 23637, this proposed regulation applies and incorporates by reference proposed California Code of Regulations, title

18, section 23637-3, and the term "qualified taxpayer" in that proposed regulation shall have the same effect in this proposed regulation.

Proposed California Code of Regulations, title 18, section 23636-4, provides rules and examples for determining qualified wages for purposes of the Joint Strike Fighter Wage Credit. Specifically provided are rules regarding the requirement that qualified wages are limited to that portion of wages that constitute direct labor costs as that term is used in the Internal Revenue Code section 263A. Also included are rules regarding the term employee and the fact that wages for engineering, design and testing activities specifically qualify for the Joint Strike Fighter Wage Credit. Finally, the amount of qualified wages is provided in this proposed regulation.

Proposed California Code of Regulations, title 18, section 23636-5, provides rules and examples for determining who is a qualified employee for purposes of the Joint Strike Fighter Wage Credit. Specifically, this proposed regulation defines the term "employee" as an employee described in Unemployment Insurance Code sections 13004, 13004.1 and 13004.5. This proposed regulation also explains that a qualified employee must perform services in this state and those services must be at least 90% directly related to the qualified taxpayer's contract or subcontract to manufacture property for ultimate use in a Joint Strike Fighter. This proposed regulation provides guidance on computing the \$10,000 per employee wage limitation. Finally, this proposed regulation defines the term "directly related" for determining whether an employee's services qualify for the Joint Strike Fighter Wage Credit.

Proposed California Code of Regulations, title 18, section 23636-6, provides rules applicable to Joint Strike Fighter contract bidding. This proposed regulation provides that no Joint Strike Fighter Wage Credit shall be allowed unless the credit is reflected within the bid that forms the basis for the taxpayer's contract or subcontract to manufacture property for ultimate use in a Joint Strike Fighter. Specifically, this proposed regulation defines the term "bid," "reflected within the bid," and "credit allowable." This proposed regulation also contains examples of bids within which the credit is reflected. Finally, this proposed regulation provides that in the case of a pass-through entity, the amount of the credit reflected on the bid is the amount of the credit that the entity expects to pass-through to the partners or shareholders.

Proposed California Code of Regulations, title 18, section 23636-7, provides rules for determining the length of the carryforward period for the Joint Strike Fighter Wage Credit. In addition, this proposed regulation provides rules for carryforwards for pass-through entities and carryforwards permitted after the sunset date of Revenue and Taxation Code section 23636.

Proposed California Code of Regulations, title 18, section 23636-8, provides rules illustrating which books and records should be maintained to substantiate any Joint Strike Fighter Wage Credit claimed. Specifically, this proposed regulation discusses the general burden of proof and identifies the books and records that should be maintained.

Proposed California Code of Regulations, title 18, section 23636-9, provides miscellaneous rules applicable to the Joint Strike Fighter Wage Credit. Specifically provided are the effective dates of the Joint Strike Fighter Wage Credit, and the interaction of the Joint Strike Fighter Wage Credit with the Enterprise Zone Hiring Credit. The rules and cross-references in this proposed

regulation have been drawn from other places in the Revenue and Taxation Code that may not otherwise be readily apparent to taxpayers who wish to claim the Joint Strike Fighter Wage Credit.

2. Joint Strike Fighter Property Credit

Proposed California Code of Regulations, title 18, sections 17053.37-0 through 17053.37-11

These proposed regulations are organized as a series of related regulations that are separated by subject matter area. Where appropriate or required, specific cross-reference information has been provided in the text of the applicable proposed regulations. Moreover, due to the complexity and length of both the statute and these proposed regulations, proposed California Code of Regulations, title 18, section 17053.37-0, contains a non-substantive, non-binding table of contents designed to assist readers in locating specific subject matter areas in proposed California Code of Regulations, title 18, sections 17053.37-1 through 17053.37-11.

Proposed California Code of Regulations, title 18, section 17053.37-1, provides rules regarding the amount of the Joint Strike Fighter Property Credit, the years in which the Joint Strike Fighter Property Credit may be claimed, cross-reference information and general reference information regarding proposed California Code of Regulations, title 18, sections 17053.37-1 through 17053.37-11.

Proposed California Code of Regulations, title 18, section 17053.37-2, provides general definitions for certain words and phrases used in Revenue and Taxation Code section 17053.37 and proposed California Code of Regulations, title 18, sections 17053.37-1 through 17053.37-11. Specifically, definitions of "capitalized labor," "fabricating," "Joint Strike Fighter," "initial contract or subcontract," "Joint Strike Fighter Program," "manufacturing," "packaging," "placed in service," "product for ultimate use in a Joint Strike Fighter," "primarily," "process," "processing," and "qualified activities" are provided. Where appropriate or specifically required by the statutory language of Revenue and Taxation Code section 17053.37, some of these definitions are further clarified by reference to existing California or federal law. For example, Revenue and Taxation Code section 17053.37 requires that in order for capitalized labor costs to be treated as qualified costs, they must be ". . . direct costs as defined in Internal Revenue Code section 263A allocable to the construction or modification . . ." of qualified property. Thus, this proposed regulation incorporates the uniform capitalization rules set forth in Internal Revenue Code section 263A and Treasury Regulation section 1.263A-1.

Proposed California Code of Regulations, title 18, section 17053.37-3, provides rules and examples for determining who is a qualified taxpayer for purposes of the Joint Strike Fighter Property Credit. Revenue and Taxation Code section 17053.37 requires that a qualified taxpayer be "under an initial contract or subcontract to manufacture property for ultimate use in a Joint Strike Fighter." This proposed regulation defines the terms "initial contract" and "initial subcontract" and provides examples to illustrate the application of these definitions to contractual relationships. This proposed regulation also provides that for pass-through entities, the determination of whether a taxpayer is a qualified taxpayer shall be made at the entity level. This proposed regulation applies well-established California income tax principles to clarify that

the qualified taxpayer determination is to be made at the pass-through entity level (whether a partnership or S corporation), thereby allowing the Joint Strike Fighter Property Credit to be passed through to the partners or shareholders who might not directly satisfy the "qualified taxpayer" requirement. Finally, this proposed regulation illustrates the current California law whereby an S corporation may claim one-third of the Joint Strike Fighter Property Credit for purposes of the entity-level tax imposed on S corporations by Chapter 4.5 of Part 11 of the Revenue and Taxation Code and pass-through 100% of the Joint Strike Fighter Property Credit, with reduction for any amount utilized at the entity-level, to its shareholders.

Proposed California Code of Regulations, title 18, section 17053.37-4, provides rules and examples for determining what costs may be considered qualified costs for purposes of the Joint Strike Fighter Property Credit. Specifically provided are rules regarding the requirements that California sales or use tax be paid and that costs be properly chargeable to the taxpayer's capital account. Also included are rules regarding which capitalized labor costs are treated as direct costs and are thus eligible for the Joint Strike Fighter Property Credit (including labor costs under third-party contracts), and binding contract rules (including successor or replacement contracts, option contracts and conditional contracts) specifying how costs actually paid prior to January 1, 2001, are treated. Moreover, since qualified costs include only costs paid or incurred for qualified property on or after January 1, 2001, the proposed regulation provides guidance for how costs actually paid before and after January 1, 2001, pursuant to a binding contract, successor or replacement contract, option contract and conditional contract, should be allocated for purposes of the Joint Strike Fighter Property Credit.

Proposed California Code of Regulations, title 18, section 17053.37-5, provides rules and examples for determining what types of property may be treated as qualified property for purposes of the Joint Strike Fighter Property Credit. Specifically, this proposed regulation describes and illustrates the general requirement that qualified property be tangible personal property defined in Internal Revenue Code section 1245(a)(3)(A). This proposed regulation also explains that qualified property must be used in qualified activities to manufacture a product for ultimate use in a Joint Strike Fighter. The proposed regulation provides that this requirement will be satisfied if the qualified property is primarily used to manufacture a product that is properly treated as inventory of the taxpayer and is designed to be physically installed in or attached to a Joint Strike Fighter. Also included are rules regarding the types of property that are specifically excluded from being qualified property and the movement of used property from another state or country into California.

Proposed California Code of Regulations, title 18, section 17053.37-6, provides rules applicable to leases of qualified property. Specifically, this proposed regulation describes and illustrates the statutory rules for distinguishing operating leases (leases not treated as sales for California sales and use tax purposes) from finance leases (leases treated as sales for California sales and use tax purposes), as well as the statutory requirements applicable to each type of lease. This proposed regulation also contains rules regarding the amount of Joint Strike Fighter Property Credit a lessee may claim and certain lessor reporting requirements applicable to operating leases. Finally, this proposed regulation clarifies who must pay the California sales or use tax in order for the lessee in a leasing transaction to claim the Joint Strike Fighter Property Credit.

Proposed California Code of Regulations, title 18, section 17053.37-7, provides rules applicable to Joint Strike Fighter contract bidding. This proposed regulation provides that no Joint Strike Fighter Property Credit shall be allowed unless the credit is reflected within the bid that forms the basis for the taxpayer's contract or subcontract to manufacture property for ultimate use in a Joint Strike Fighter. Specifically, this proposed regulation defines the term "bid," "reflected within the bid," and "credit allowable." This proposed regulation also contains examples of bids within which the credit is reflected. Finally, this proposed regulation provides that in the case of a pass-through entity, the amount of the credit reflected on the bid is the amount of the credit that the entity expects to pass-through to the partners or shareholders.

Proposed California Code of Regulations, title 18, section 17053.37-8, provides rules for recapturing a previously allowed Joint Strike Fighter Property Credit where a disposition has occurred within one year of the placed in service date. This proposed regulation defines a disposition to include any removal of property from California, a sale or other disposition to an unrelated party (as defined in Internal Revenue Code sections 267, 318, or 707), a conversion to a primarily non-qualified use, or an acquisition by a lessee of qualified property that is being leased by such lessee. This proposed regulation also provides rules regarding the applicable recapture periods, rules regarding the adjustment of carryforwards when a disposition occurs, and special recapture rules applicable to partners or shareholders of pass-through entities who were allowed the Joint Strike Fighter Property Credit.

Proposed California Code of Regulations, title 18, section 17053.37-9, provides rules for determining the length of the carryforward period for the Joint Strike Fighter Property Credit. In addition, this proposed regulation provides rules for carryforwards for pass-through entities and carryforwards permitted after the sunset date of Revenue and Taxation Code Section 17053.37.

Proposed California Code of Regulations, title 18, section 17053.37-10, provides rules illustrating which books and records should be maintained to substantiate any Joint Strike Fighter Property Credit claimed. Specifically, this proposed regulation discusses the general burden of proof, identifies the books and records that should be maintained, and specifies the lessor's reporting requirement in an operating lease transaction. This proposed regulation also contains rules regarding when the taxpayer's substantiation requirement will be deemed satisfied with respect to the amount upon which California sales or use tax has been paid pursuant to "time and materials," "lump-sum," or "turnkey" contracts.

Proposed California Code of Regulations, title 18, section 17053.37-11, provides miscellaneous rules applicable to the Joint Strike Fighter Property Credit. Specifically provided are the effective dates of the Joint Strike Fighter Property Credit, and the interaction of the Joint Strike Fighter Property Credit with the Manufacturers' Investment Credit and the Enterprise Zone Sales or Use Tax Credit. The rules and cross-references in this proposed regulation have been drawn from other places in the Revenue and Taxation Code that may not otherwise be readily apparent to taxpayers who wish to claim the Joint Strike Fighter Property Credit.

Proposed California Code of Regulations, title 18, sections 23637-0 through 23637-11

These proposed regulations are organized as a series of related regulations that are separated by subject matter area. Where appropriate or required, specific cross-reference information has been provided in the text of the applicable proposed regulations. Moreover, due to the complexity and length of both the statute and these proposed regulations, proposed California Code of Regulations, title 18, section 23637-0, contains a non-substantive, non-binding table of contents designed to assist readers in locating specific subject matter areas in proposed California Code of Regulations, title 18, sections 23637-1 through 23637-11.

Proposed California Code of Regulations, title 18, section 23637-1, provides rules regarding the amount of the Joint Strike Fighter Property Credit, the years in which the Joint Strike Fighter Property Credit may be claimed, cross-reference information and general reference information regarding proposed California Code of Regulations, title 18, sections 23637-1 through 23637-11.

Proposed California Code of Regulations, title 18, section 23637-2, provides general definitions for certain words and phrases used in Revenue and Taxation Code section 23637 and proposed California Code of Regulations, title 18, sections 23637-1 through 23637-11. Specifically, definitions of "capitalized labor," "fabricating," "Joint Strike Fighter," "initial contract or subcontract," "Joint Strike Fighter Program," "manufacturing," "packaging," "placed in service," "product for ultimate use in a Joint Strike Fighter," "primarily," "process," "processing," and "qualified activities" are provided. Where appropriate or specifically required by the statutory language of Revenue and Taxation Code section 23637, some of these definitions are further clarified by reference to existing California or federal law. For example, Revenue and Taxation Code section 23637 requires that in order for capitalized labor costs to be treated as qualified costs, they must be ". . . direct costs as defined in Internal Revenue Code section 263A allocable to the construction or modification . . ." of qualified property. Thus, this proposed regulation incorporates the uniform capitalization rules set forth in Internal Revenue Code section 263A and Treasury Regulation section 1.263A-1.

Proposed California Code of Regulations, title 18, section 23637-3, provides rules and examples for determining who is a qualified taxpayer for purposes of the Joint Strike Fighter Property Credit. Revenue and Taxation Code section 23637 requires that a qualified taxpayer be "under an initial contract or subcontract to manufacture property for ultimate use in a Joint Strike Fighter." This proposed regulation defines the terms "initial contract" and "initial subcontract" and provides examples to illustrate the application of these definitions to contractual relationships. This proposed regulation also provides that for pass-through entities, the determination of whether a taxpayer is a qualified taxpayer shall be made at the entity level. This proposed regulation applies well-established California franchise tax principles to clarify that the qualified taxpayer determination is to be made at the pass-through entity level (whether a partnership or S corporation), thereby allowing the Joint Strike Fighter Property Credit to be passed through to the partners or shareholders who might not directly satisfy the "qualified taxpayer" requirement. Finally, this regulation illustrates the current California law whereby an S corporation may claim one-third of the Joint Strike Fighter Property Credit for purposes of the entity-level tax imposed on S corporations by Chapter 4.5 of Part 11 of the Revenue and

Taxation Code and pass-through 100% of the Joint Strike Fighter Property Credit, with reduction for any amount utilized at the entity-level, to its shareholders.

Proposed California Code of Regulations, title 18, section 23637-4, provides rules and examples for determining what costs may be considered qualified costs for purposes of the Joint Strike Fighter Property Credit. Specifically provided are rules regarding the requirements that California sales or use tax be paid and that costs be properly chargeable to the taxpayer's capital account. Also included are rules regarding which capitalized labor costs are treated as direct costs and are thus eligible for the Joint Strike Fighter Property Credit (including labor costs under third-party contracts), and binding contract rules (including successor or replacement contracts, option contracts and conditional contracts) specifying how costs actually paid prior to January 1, 2001, are treated. Moreover, since qualified costs include only costs paid or incurred for qualified property on or after January 1, 2001, the proposed regulation provides guidance for how costs actually paid before and after January 1, 2001, pursuant to a binding contract, successor or replacement contract, option contract and conditional contract, should be allocated for purposes of the Joint Strike Fighter Property Credit.

Proposed California Code of Regulations, title 18, section 23637-5, provides rules and examples for determining what types of property may be treated as qualified property for purposes of the Joint Strike Fighter Property Credit. Specifically, this proposed regulation describes and illustrates the general requirement that qualified property be tangible personal property defined in Internal Revenue Code section 1245(a)(3)(A). This proposed regulation also explains that qualified property must be used in qualified activities to manufacture a product for ultimate use in a Joint Strike Fighter. The proposed regulation provides that this requirement will be satisfied if the qualified property is primarily used to manufacture a product that is properly treated as inventory of the taxpayer and is designed to be physically installed in or attached to a Joint Strike Fighter. Also included are rules regarding the types of property that are specifically excluded from being qualified property and the movement of used property from another state or country into California.

Proposed California Code of Regulations, title 18, section 23637-6, provides rules applicable to leases of qualified property. Specifically, this proposed regulation describes and illustrates the statutory rules for distinguishing operating leases (leases not treated as sales for California sales and use tax purposes) from finance leases (leases treated as sales for California sales and use tax purposes), as well as the statutory requirements applicable to each type of lease. This proposed regulation also contains rules regarding the amount of Joint Strike Fighter Property Credit a lessee may claim and certain lessor reporting requirements applicable to operating leases. Finally, this proposed regulation clarifies who must pay the California sales or use tax in order for the lessee in a leasing transaction to claim the Joint Strike Fighter Property Credit.

Proposed California Code of Regulations, title 18, section 23637-7, provides rules applicable to Joint Strike Fighter contract bidding. This proposed regulation provides that no Joint Strike Fighter Property Credit shall be allowed unless the credit is reflected within the bid that forms the basis for the taxpayer's contract or subcontract to manufacture property for ultimate use in a Joint Strike Fighter. Specifically, this proposed regulation defines the term "bid," "reflected within the bid," and "credit allowable." This proposed regulation also contains examples of bids

within which the credit is reflected. Finally, this proposed regulation provides that in the case of a pass-through entity, the amount of the credit reflected on the bid is the amount of the credit that the entity expects to pass-through to the partners or shareholders.

Proposed California Code of Regulations, title 18, section 23637-8, provides rules for recapturing a previously allowed Joint Strike Fighter Property Credit where a disposition has occurred within one year of the placed in service date. This proposed regulation defines a disposition to include any removal of property from California, a sale or other disposition to an unrelated party (as defined in Internal Revenue Code sections 267, 318, or 707), a conversion to a primarily non-qualified use, or an acquisition by a lessee of qualified property that is being leased by such lessee. This proposed regulation also provides rules regarding the applicable recapture periods, rules regarding the adjustment of carryforwards when a disposition occurs, and special recapture rules applicable to partners or shareholders of pass-through entities who were allowed the Joint Strike Fighter Property Credit.

Proposed California Code of Regulations, title 18, section 23637-9, provides rules for determining the length of the carryforward period for the Joint Strike Fighter Property Credit. In addition, this proposed regulation provides rules for carryforwards for pass-through entities and carryforwards permitted after the sunset date of Revenue and Taxation Code section 23637.

Proposed California Code of Regulations, title 18, section 23637-10, provides rules illustrating which books and records should be maintained to substantiate any Joint Strike Fighter Property Credit claimed. Specifically, this proposed regulation discusses the general burden of proof, identifies the books and records that should be maintained, and specifies the lessor's reporting requirement in an operating lease transaction. This proposed regulation also contains rules regarding when the taxpayer's substantiation requirement will be deemed satisfied with respect to the amount upon which California sales or use tax has been paid pursuant to "time and materials," "lump-sum," or "turnkey" contracts.

Proposed California Code of Regulations, title 18, section 23637-11, provides miscellaneous rules applicable to the Joint Strike Fighter Property Credit. Specifically provided are the effective dates of the Joint Strike Fighter Property Credit, and the interaction of the Joint Strike Fighter Property Credit with the Manufacturers' Investment Credit and the Enterprise Zone Sales or Use Tax Credit. The rules and cross-references in this proposed regulation have been drawn from other places in the Revenue and Taxation Code that may not otherwise be readily apparent to taxpayers who wish to claim the Joint Strike Fighter Property Credit.

DISCLOSURES REGARDING THE PROPOSED REGULATORY ACTION

Mandate on local agencies and school districts: None.

Cost or savings to any state agency: None.

Cost to any local agency or school district which must be reimbursed under Part 7, commencing with Government Code section 17500, of Division 4: None.

Other non-discretionary cost or savings imposed upon local agencies: None.

Cost or savings in federal funding to the state: None.

Significant statewide adverse economic impact directly affecting business including the ability of California businesses to compete with businesses in other states: Impacts in this area, if any, are the result of the statute and not the regulations per se. In making this determination, Franchise Tax Board staff has performed an analysis to comply with Government Code sections 11346.3, subdivisions (a) & (b).

Cost to directly affected private persons/businesses potential: Impacts in this area, if any, are the result of the statute and not the regulations per se.

Significant effect on the creation or elimination of jobs in the state: Impacts in this area, if any, are the result of the statute and not the regulations per se.

Significant effect on the creation of new businesses or elimination of existing businesses within the state: Impacts in this area, if any, are the result of the statute and not the regulations per se.

Significant effect on the expansion of businesses currently doing business within the state: Impacts in this area, if any, are the result of the statute and not the regulations per se.

Effect on small business: The proposed regulations help small business to understand the Joint Strike Fighter Wage Credit and the Joint Strike Fighter Property Credit and how they might benefit from those credits by interpreting and explaining the various provisions of the credits.

Significant effect on housing costs: None.

CONSIDERATION OF ALTERNATIVES

In accordance with Government Code section 11346.5, subdivision (a)(13), the Board must determine that no reasonable alternative it considered or that has otherwise been identified and brought to its attention it would be more effective in carrying out the purpose for which the action is proposed or would be as effective and less burdensome to affected private persons than the proposed regulatory action.

AVAILABILITY OF STATEMENT OF REASONS AND TEXT OF PROPOSED REGULATIONS

The Franchise Tax Board has prepared an initial statement of the reasons for the proposed regulatory action. The express terms of the proposed regulatory action, the initial statement of the reasons for the regulatory action, and all the information upon which the proposed regulatory action is based are available upon request from the agency officer named below. When the final statement of reasons is available, it can be obtained by contacting the agency officer named below, or by accessing the Franchise Tax Board's website at <http://www.ftb.ca.gov>.

CHANGE OR MODIFICATION OF ACTIONS

The three-member Franchise Tax Board may adopt the proposed regulatory action after consideration of any comments received during the comment period. Government Code section 15702, subdivision (b), provides for consideration by the three-member Board of any proposed regulatory action, if any person makes such a request. If a request is received, the three-member Board will consider the proposed regulatory action prior to adoption.

The regulations and amendments may also be adopted with modifications if the changes are nonsubstantive or the resulting regulations are sufficiently related to the text made available to the public so that the public was adequately placed on notice that the regulations as modified could result from that originally proposed. The text of the regulations as modified will be made available to the public at least 15 days prior to the date on which the regulations are adopted. Requests for copies of any modified regulations should be sent to the attention of the agency officer named below.

ADDITIONAL COMMENTS

If you plan on attending or making an oral presentation at the regulation hearing, please contact the agency officer named below.

The hearing room is accessible to persons with physical disabilities. Any person planning to attend the hearing, who is in need of a language interpreter, including sign language should contact the officer named below at least two weeks prior to the hearing so that the services of an interpreter may be arranged.

CONTACT

All inquiries concerning this notice or the hearing should be directed to Colleen Berwick at Franchise Tax Board, Legal Branch, P.O. Box 1720, Rancho Cordova, CA 95741-1720; telephone (916) 845-3306; Fax (916) 845-3648; E-Mail: colleen.berwick@ftb.ca.gov, or the designated backup, Doug Powers; Tel.: (916) 845-4962; Fax: (916) 845-3648; E-Mail: doug.powers@ftb.ca.gov. In addition, all questions on the substance of the proposed regulation can be directed to Geoff Way: Tel. (916) 845-6351. This notice, the initial statement of reasons and express terms of the proposed regulations are also available at the Franchise Tax Board's website at www.ftb.ca.gov.