

Legal Division Guidance 2012-03-01

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

(History: This Legal Division Guidance is intended to supersede **Legal Division Guidance 2011-06-01, which was subsequently withdrawn by 2011-07-01.**)

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

A: No. California law modifies the federal definition of "gross receipts." Revenue and Taxation Code (RTC) section 17052.12, subdivision (g), paragraph (3), and section 23609, subdivision (h), paragraph (3), provide as follows:

Section 41(c)(7) of the Internal Revenue Code, relating to gross receipts, is modified to take into account only those gross receipts from the sale of property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business that is delivered or shipped to a purchaser within this state, regardless of f.o.b. point or any other condition of sale.

This limitation has the effect of excluding all gross receipts other than those that are "sales of property held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business that is delivered or shipped to a purchaser within this state."

Q: Can a Taxpayer with California Qualified Research Expenses and Zero (\$0) California Gross Receipts under RTC sections 17052.12, subdivision (g), paragraph (3), or section 23609, subdivision (h), paragraph (3), claim the regular incremental Research and Development credit?

A: Yes. The incremental research credit is computed by multiplying the applicable California credit rate for the taxable year (15% for taxable years beginning on or after 1/1/2000; 12% for 1999; 11% for 1997 and 1998; and 8% for years before 1997) by the excess of the taxpayer's current year qualified research expenses over a "base amount." The base amount is defined as the taxpayer's "fixed base percentage"¹ times the taxpayer's average annual gross receipts for the four taxable years preceding the taxable year for which the credit is being determined. But "in no event shall the base amount be less than 50 percent of the qualified research expenses for the credit year." (IRC § 41(c)(2)). If the computed "base amount" is less than the "minimum base amount," then for taxable years 2000 and later the credit is equal to 15% of qualified

¹ If a taxpayer has no gross receipts in the base years of 1984 to 1988, it is considered a "start-up" company under IRC § 41(c)(3)(B) and required to use fixed base percentages enumerated in IRC § 41(c)(3)(B)(ii).

research expenses in excess of the "minimum base amount" [50% of QREs]. In cases where there are no gross receipts, as defined in RTC sections 17052.12(g)(3) or 23609(h)(3), for taxable years 2000 and later, the California credit would be equal to 7.5% of the qualified research expenses for the credit year, or the reduced credit under IRC § 280(c)(3).

FTB may publish additional guidelines on the mechanics of taking the credit for taxpayers with only gross receipts excluded under RTC sections 17052.12, subdivision (g), paragraph (3), and 23609, subdivision (h), paragraph (3).

Q: What does this mean for a taxpayer with California Qualified Research Expenses and Gross Receipts from the sale of tangible property, such as manufacturers?

A: The rules are the same for all taxpayers. If the computed base amount is less than the minimum base amount, the taxpayer is entitled to a credit equal to one-half applicable California credit rate for the taxable year (7.5% for 2000 and later) of qualified research expenses for the credit year, or the reduced credit under IRC § 280(c)(3). However, if the computed base amount is greater than the minimum base amount [50% of qualified research expenses for the credit year], the credit would be equal to the applicable California credit rate (15% for 2000 and later) of the qualified research expenses in excess of the computed base amount. The taxpayer earns the credit only for the portion of qualified spending that *exceeds* the computed base amount, which is determined by reference to the taxpayer's QREs and gross receipts in prior years. The amount of QREs allowed in the credit calculation for such a taxpayer will range between 50 percent and zero, depending on the excess QREs over the base amount. Having no excess QREs will result in no credit.

If a taxpayer with gross receipts, as defined for California purposes, cannot substantiate its base amount and/or fixed-base percentage calculations for any reason, the taxpayer cannot simply claim that the "minimum base amount" applies in lieu of calculating the "fixed-base percentage." Such a taxpayer is not entitled to the credit for lack of substantiation.