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SUBJECT: Applying the limitation placed on the utilization of credits by Section 23036(i) of the California Revenue and Taxation Code (the "Section 23036(i) Limitation") with respect to assignments and certain other business circumstances.

QUESTIONS PRESENTED

- (1) Parent, a C corporation, owned 100% of Subsidiary, a limited liability company. In Year A, Subsidiary elected to be classified as an association taxable as a corporation. Research credits, as provided by California Revenue and Taxation Code ("CRTC") section 23609, were generated by Subsidiary in Year A. In Year B, Subsidiary elected to be classified as a disregarded entity. Research credits generated by Parent in Year B were attributable to Subsidiary. In Year C, Subsidiary elected to be classified as an association taxable as a corporation and generated research credits. In Year D, Subsidiary generated research credits and dissolved at the end of the year in a transaction in which Internal Revenue Code ("IRC") section 381 applied. For Year A, Year B, Year C, and Year D, does the Section 23036(i) Limitation apply to the research credits attributable to Subsidiary?
- (2) Parent, a C corporation, owned 100% of Subsidiary, a limited liability company. In Year A, Subsidiary was a disregarded entity. Research credits generated by Parent in Year A were attributable to Subsidiary (the "Year A Research Credits"). In Year B, pursuant to CRTC section 23663, Parent assigned the Year A Research Credits to Company X, a C corporation and a member of Parent's combined reporting group. Does the Section 23036(i) Limitation apply to the Year A Research Credits after being assigned to Company X?
- (3) Parent, a C corporation, owned 100% of Subsidiary, a limited liability company. In Year C, Subsidiary was a disregarded entity. Research credits generated by Parent in

Year C were attributable to Subsidiary (the "Year C Research Credits"). In Year D, Company Z, a C corporation, acquired a partial membership interest in Subsidiary and Subsidiary elected to be classified as a partnership. Are the Year C Research Credits allowable against Parent's tax liability in Year D based on Parent's distributive share of Subsidiary's income?

CONCLUSION

- (1) The Section 23036(i) Limitation does not apply to the research credits generated in Year A, Year C, and Year D. The Section 23036(i) Limitation applies to the research credits generated in Year B. Notably, the dissolution of Subsidiary would not alter the application of the Section 23036(i) Limitation to the research credits generated in Year B, and that limitation would continue to apply to any future carryover of those credits.
- (2) After the assignment to Company X, the Section 23036(i) Limitation continues to apply to the Year A Research Credits since the limitation is permanent regardless of whether there was an assignment of the credit or the owner of the credit changed per a corporate reorganization event. Because the Section 23036(i) Limitation applies to the Year A Research Credits, Subsidiary's income must flow to Company X in order for any of the Year A Research Credits to be allowable against Company X's tax.
- (3) The Section 23036(i) Limitation applies to the Year C Research Credits. As a result, the Year C Research Credits would not be allowable against Parent's tax liability in Year D because Subsidiary was no longer a disregarded entity.

ANALYSIS AND DISCUSSION

When a disregarded entity performs activities that generate credits, the credits are allowed to the owner of the disregarded entity.¹ However, CRTC section 23036(i) imposes a limitation on the amount of credits attributable to disregarded entities that can be allowed against a taxpayer's tax (defined above as the Section 23036(i) Limitation). The Section 23036(i) Limitation works by limiting the amount of credits allowable against a taxpayer's tax to the amount of the taxpayer's regular tax that is attributable to the income of the disregarded entity. See CRTC section 23036(i)(2) for the mechanics of how the limitation is computed.

The Limitation Attaches to a Credit at the Time of Generation and is a Permanent Limitation.

The Section 23036(i) Limitation attaches to a credit at the time the credit is generated and becomes a permanent limitation, unless specifically removed by another statute. CRTC section 23036(i)(1) provides that the limitation applies to "the amount of any credit or credit carryforward allowable for any taxable year attributable to the disregarded business entity."² Changing the circumstances around the credit does not remove the limitation without specific statutory language. For example, the Section 23036(i) Limitation is specifically

¹ See CRTC § 23038 and its underlying regulations.

² CRTC § 23036(i)(1).

removed by statute when a credit is assigned under the motion picture production credit statute (the "Film Credit Statute")³ or when a credit is sold pursuant to the Film Credit Statute.⁴ However, the low-income housing credit statute, which has a similar structure to the Film Credit Statute, does not include language removing the limitation when the credit is assigned, with the result that the limitation remains.⁵

See also Senate Bill Number 28 of the 2007–2008 First Extraordinary Session ("Senate Bill No. 28") which was chaptered on October 1, 2008, just days after the California Legislature enacted the general credit assignment statute in CRTC section 23663. Section 8 of Senate Bill No. 28 includes off-code language for the purpose of "clarifying" that, under the recently passed general credit assignment statute of CRTC section 23663, any limitation that applies to an assigned credit attaches to the credit in the hands of both the assignor and assignee.⁶

The mechanics of how the Section 23036(i) Limitation attaches to a credit, unless specifically removed by statute, can also be seen in the Film Credit Statute as discussed above. Less than five months after the enactment of Senate Bill No. 28, the Film Credit Statute was chaptered on February 20, 2009.⁷ By enacting the Film Credit Statute, the California Legislature demonstrated its awareness that a statutory change was required in order to disable the Section 23036(i) Limitation.

Under the plain language of CRTC section 23036(i), the Section 23036(i) Limitation permanently attaches to a credit at the time the credit is generated. This conclusion is illustrated by the California Legislature's intent statement in Senate Bill No. 28 and the Film Credit Statute's specific language removing the Section 23036(i) Limitation in certain instances, in contrast to the low-income housing credit statute which does not allow for the removal of the limitation. Accordingly, once the generation of a credit is attributed to a disregarded business entity, the Section 23036(i) Limitation attaches to that credit permanently, unless specifically removed by statute.

Based on the above, the Section 23036(i) Limitation applies to Question 1 as follows:

a. Year A

In Year A, because Subsidiary was an association taxable as a corporation, it was not "disregarded for tax purposes pursuant to Section 23038 and any regulations thereunder."⁸ Accordingly, the Section 23036(i) Limitation does not apply to the research credits generated by Subsidiary in Year A.

³ CRTC § 23685(c)(1).

⁴ CRTC § 23685(c)(10).

⁵ CRTC § 23610.5.

⁶ Sen. Bill No. 28 (2007–2008 1st Ex. Sess.), §§ 8(a) and (c).

⁷ Sen. Bill No. 15 (2009–2010 3rd Ex. Sess.).

⁸ CRTC § 23036(i)(1).

b. Year B

In Year B, because Subsidiary was "disregarded for tax purposes pursuant to Section 23038 and any regulations thereunder," the Section 23036(i) Limitation applies to the research credits generated by Parent in Year B that are attributable to Subsidiary. On the other hand, the Section 23036(i) Limitation continues to be inapplicable to the research credits generated by Subsidiary in Year A.

c. Year C

In Year C, because Subsidiary was, once again, an association taxable as a corporation, Subsidiary was not "disregarded for tax purposes pursuant to Section 23038 and any regulations thereunder."⁹ Accordingly, the Section 23036(i) Limitation does not apply to the research credits generated by Subsidiary in Year C. However, the research credits generated by Parent in Year B that are attributable to Subsidiary remain subject to the Section 23036(i) Limitation while the research credits generated by Subsidiary in Year A are not.

It should be noted that Parent could not have any of the research credits generated in Year B allowed against Parent's tax in Year C since none of Parent's regular tax in Year C was attributable to the income of the disregarded entity.¹⁰

d. Year D

In Year D, because Subsidiary was an association taxable as a corporation, it was not "disregarded for tax purposes pursuant to Section 23038 and any regulations thereunder."¹¹ Accordingly, the Section 23036(i) Limitation does not apply to the research credits generated by Subsidiary in Year D. Similar to above, the research credits generated by Parent in Year B that are attributable to Subsidiary remain subject to the Section 23036(i) Limitation while the research credits generated by Subsidiary in Years A and C are not.

Subsidiary's dissolution does not impact the application of the Section 23036(i) Limitation. The Year B research credits are subject to the Section 23036(i) Limitation so that the credits are only allowable against Parent's tax to the extent the tax is based on "income attributable to the disregarded business entity that generated the credit or credit carryover."¹² Since the disregarded entity no longer existed, Parent or any other taxpayer had no possibility of having their tax include "income attributable to the disregarded business entity that generated the credit or credit carryover."¹³ Therefore, after Subsidiary's dissolution, Parent will never be able to utilize the Year B research credits.

Based on the above, the Section 23036(i) Limitation applies to Question 2 as follows:

⁹ CRTC § 23036(i)(1).

¹⁰ CRTC §23036(i)(2).

¹¹ CRTC §23036(i)(1).

¹² CRTC §23036(i)(2).

¹³ CRTC §23036(i)(2).

The Section 23036(i) Limitation continues to apply to the Year A Research Credits attributable to Subsidiary in Year A after the assignment to Company X per the above analysis. Because Subsidiary's income does not flow to Company X, the Section 23036(i) Limitation would prevent any of the Year A Research Credits from being allowed against Company X's tax.

The Section 23036(i) Limitation applies to the Year C Research Credits because the credits were generated by Parent and attributable to Subsidiary while Subsidiary was a disregarded entity. Although a portion of Subsidiary's income in Year D flows to Parent, the Year C Research Credits cannot be allowed against Parent's tax since Subsidiary is no longer a disregarded entity. See CRTC section 23036(i)(2), which requires that income attributable to the "disregarded entity" be included in Parent's regular tax in order for credits subject to the Section 23036(i) Limitation to be allowed against Parent's tax.

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