CHAPTER OF CONTENTS:

9000 TAX CREDITS

Once the proper tax rate is applied to California net income, tax credits are subtracted in determining the proper tax under California law. The rules for determining tax credits are very detailed, and frequently the rules will change from year to year. An in-depth discussion of the specific rules for each credit is beyond the scope of this manual. Instead, this section of the manual is intended only to provide a general overview of many of the available credits. If you are examining tax credits refer to the specific statute for the credit and the year involved.

9010 General Information

Tax credits must reduce tax in the following order (R&TC §23036(c)):

- Credits, which cannot be carried over
- Credits, which can be carried over
- Alternative Minimum Tax credit (see MATM 8580)
- Credits for taxes withheld.

Credits cannot reduce tax below the minimum franchise tax. Additionally, only the credits specifically listed in R&TC §23036(d)(1) may reduce regular tax below the tentative minimum tax, and then only after the alternative minimum tax credit has been allowed. In the Appeal of NASSCO, 2010,SBE-001, November 17, 2010, the Board of Equalization allowed the Enterprise Zone Credit (EZ) and the Manufacturers' Investment Credit (MIC) to reduce AMT. See FTB Notice 2011-02. Therefore, the EZ, MIC, and carryovers from certain repealed versions of the solar energy credit are allowed to offset the AMT.

Generally, the amount of credit that exceeds the minimum franchise or the tentative minimum tax may be carried over to offset tax in subsequent years. A credit may be carried over regardless of whether the statute providing for the credit has expired or been repealed.

For tax years beginning before 1/1/2008, unless otherwise specified in the statute, tax credits may only be claimed by the taxpayer incurring the cost (*Appeal of AeroVironment, Inc*.,97-SBE-001., January 10, 1997 and *Appeal of Guy F. Atkinson Company, Cal. State Bd. of Equal.*, March 19, 1997)(As of January 1, 1992, if two or more taxpayers share in the costs, then each taxpayer may claim the tax credit in proportion to the costs paid or incurred. (R&TC §23036(g))

For taxable years beginning prior to 7/1/2008, unless specifically stated otherwise (i.e., low-income housing, Enterprise Zone wage and LAMBRA wage credits), corporations that are members of a combined unitary group must compute credits and apply the credit carryovers on a separate basis. You should determine the allowable tax credits of a combined taxpayer through intrastate apportionment. (See MATM 7900 for an explanation of intrastate apportionment.

SOL Considerations for Credit Carryovers

By the time that a credit carryover is used, the statute of limitations has often expired for the prior year in which the tax credit was generated. An expired SOL will not bar you from examining the prior year credit in order to determine the effects on the open years. If a material credit was not thoroughly reviewed in the year that it was generated, iyou should review the year that the carryover results in a tax effect.

R&TC Section 19043.5 authorizes FTB to issue a Notice of Proposed Adjusted Carryover Amount (NPACA) when an examination results in a reduction of a taxpayer's reported carryover amount. NPACAs are treated as if they are proposed deficiency assessments (NPAs) and the taxpayer receives protest and appeal rights even though the exam does not result in any additional tax. (MAP 7.7)

Business Tax Credit Limitations

For tax years beginning on or after 1/1/2008 and before 1/1/2010, there is a limitation on the application of business tax credits for corporate taxpayers with income subject to tax or $500,000 or more. The limitation is equal to 50 percent of the net tax before the application of credits.

Business tax credits disallowed due to the 50% limitation may be carried over. The carryover period for disallowed credits is extended by the number of taxable years the credits were not allowed. Taxpayers are required to keep track of the disallowed business tax credits on a worksheet and provide it to the you upon request.

Repealed Credits

There are several credits that have expired but contained carryover provisions that are not covered in this manual. There are no longer separate credit forms, but the taxpayer must keep the old tax returns along with the appropriate information to substantiate that they are entitled to the credits. You can request information even on tax returns for years that are past the statute of limitations.

9015 Credit Assignment

For taxable years beginning on or after July 1, 2008, R&TC §23663 allows the assignment of credits among members of the same combined report. Assigned credits can be used to offset tax of the eligible assignee in taxable years beginning on or after January 1, 2010.

Credits available for assignment are any credits under Chapter 3.5 (tax credits commencing with section 23604) generated by the assignor or received as a distributive share from a pass-through entity beginning on or after July 1, 2008 and any credits eligible to be carried forward to the assignor's first taxable year beginning on or after July 1, 2008. The Prior Year Alternative Minimum Tax Credit is excluded from the eligible credits because it falls under Chapter 2.5 (commencing with section 23400). For a list of the eligible credits, see credit chart in the Form 100 and 100W booklets.

Assigning or Receiving Credits

The assignor of the credit is the taxpayer that originally generated the eligible credit or is allowed the credit as a distributive share item. The election to assign credits is made on the original return for the taxable year of the assignment. To elect to assign credits, the assignor completes and submits FTB 3544 – Election to Assign Credit Within Combined Reporting Group, with its original return. This election is irrevocable. Assignor cannot file an amended return to elect, modify, revoke, or change their assignment.

The eligible assignee is any affiliated corporation that is a member of the same combined reporting group (under R&TC §25101 or 25110) as the assignor on both of the following dates under either of the two scenarios:

- June 30, 2008 and the last day of the taxable year in which the credit was assigned to the assignee. This is for credits generated in taxable years before July 1, 2008 that are being carried over by the assignor, or
- The last day of the taxable year in which the credit was first allowed to the assignor and the last day of the taxable year in which the credit was assigned to the assignee. This is for credits generated in taxable years beginning on or after July 1, 2008.

Assigned credits can be used to offset an assignee's tax liability for taxable years beginning on or after January 1, 2010. Assignee completes and attaches FTB 3544A- List of Assigned Credit Received and/or Claimed by Assignee, to its return to use the assigned credits against its tax liability. Any eligible credit can only be assigned once. The assignee cannot reassign the same credit. An assignor cannot assign or allocate a specific portion of any credit, or reference to a particular asset or employee upon which earning of the credit is based. The credit is assigned solely by reference to a specific dollar amount for each year.

Credit Limitations or Restrictions

Limitations on the use of the tax credit that would have applied to the assignor will also apply to the assignee. This includes credit expiration dates, Enterprise Zone income limitation requirements, any IRC §383 limitations, single member limited liability company (SMLLC) income requirements, or any other limitations on the allowance of the tax credit that would have applied to the assignor.

Expiration dates

Assigning a credit does not extend or change the carryover period. The same credit carryover expiration date that applies to the assignor also applies to the assignee. For example, if a credit carryover expires for the assignor in 2015, it will expire for the assignee in 2015. If the assignee is not able to use the credit before the expiration date, the credit is no longer available to offset tax.

EZ Credits

The assignee is subject to the income limitations applicable to the eligible assignor with respect to the same enterprise zone for which the credit was generated. This means the assignee must have income from the same zone for which the credit was generated by the assignor. To determine the amount of credit allowed to reduce tax, the assignee must look to its own income attributable to the enterprise zone, based on its own factors, in the year the assignee seeks to use the EZ credit. If the assignee generates its own EZ credit from the same zone that generated the assigned credit, the assignee does not compute two EZ income limitations. The assignee only computes one EZ limitation based on the EZ factors for the year the assignee is using the credit, whether the credit was originally generated by the assignee or was received via an assignment.

Research Credit

The assignee does not need to be engaged in a qualified research activity to receive or use the R&D credit.

SMLLC Limitations

The limitations provided in R&TC §23036(i) apply to the assignee. Under R&TC §23036, the amount of credit which may be applied against tax is limited to the amount of the owner's regular tax attributed to the income of the SMLLC. To compute the R&TC §23036(i) limitation, the assignee should be the owner of the SMLLC. For more information regarding the limitation, see Help with Credit Assignment.

Other Assignment Provisions

Other provisions allow the assignment of credits. R&TC §23610.5(q) allows Low Income Housing Tax Credit assignment, R&TC §23685 and R&TC §23695 allow California Motion Picture and Television Production Credit assignment. The credit assignment provisions under R&TC §23663 do not override the assignments made under R&TC §23610.5(q), §23685 and §23695. Instead, they simply provide alternative permissible mechanisms under which to assign a credit. See R&TC §23610.5(q), §23685 and §23695 for their respective governing rules regarding what may be assigned and to whom. These other sections must be examined if an assignment is made under one of them rather than under R&TC §23663. See MATM 9150- Motion Picture and Television Production Credit and MATM 9110- Low Income Housing Tax Credit for additional information.

Purchase of Assigned Credits

If an agreement between the assignor and the assignee includes compensation or remuneration to receive the credit assignment, there are no tax consequences for California purposes. No deduction is allowed to the assignee and no amount received is included in the gross income of the assignor. However, there may be federal income tax consequences.

Adjustments to the Assigned Credits

The assignment of credits is an irrevocable election made on the assignor's original return. The original return is the last return filed on or before the due date (taking extensions into account) or, if no return is filed by that date, the first return filed after such date. The assignor and the assignee are jointly and severally liable for any tax, addition to tax, or penalty resulting from the disallowance of any eligible credit. Any disallowance of the credit, including credit carryovers will be considered on a case-by-case basis.

Defective credit assignments

Any assignment that does not meet the requirements of R&TC §23663 is a defective assignment. Defective assignments include, but are not limited to:

- Incomplete forms.
- Assignments made to an ineligible assignee.
- Non-specific assignments, such as listing "various" rather than a dollar amount.
- Assigning more credits than the assignor has.

Example: In its election to assign credits, X includes the name of Y but the FEIN of Z. This is a defective assignment because the identity of the assignee is uncertain.

Also, sometimes the assignment becomes defective as the credit is reduced at audit and the taxpayer does not have enough credit left to match the original assignment.

California Code of Regulations 23663-1 to 23663-5 allocation rules

California Code of Regulations (CCR) 23663-1 to 23663-5 became effective on September 18, 2018. These regulations provide the following options to allocate credit when the credit assignments are defective:

1. Standard allocation – generally, if the taxpayer assigns more credits than they actually have, the credits will be allocated to the assignee per the default allocation provisions. In other instances, the credits can be allocated back to the assignor.
2. Alternative allocation – taxpayer may make a request for an alternative allocation before first audit contact.
3. Correction of an error- taxpayer may request a cure for many defective assignments before they file the subsequent year's tax return or the year's extended due date, whichever is earlier. Until September 18, 2019, taxpayers may apply the "correction of an error" provisions of CCR 23663-4 to defective credit assignments made before the regulation became effective.

4. Unitary determination – taxpayer may request us to make a determination if the assignor and assignee are unitary for credit assignment purposes only.

   FTB Notice 2018-03 provides procedures for making these requests.

Additional Information

To learn more about credit assignment, refer to the following websites:

- Franchise Tax Board- Credit assignments
- *** **** ****** **********
- *** **** ****** ******* *** *********** ********** ******

9030 Child Care Credit

Credit for Start-Up Costs

Per R&TC §23617, for each taxable beginning on or after January 1, 1988, and before January 1, 2012, a credit is allowed for the start-up expenses of establishing a child care program or constructing a child care facility in California, to be used primarily by the children of the taxpayer's employees. The credit is 30 percent of any of the following:

- The cost paid or incurred by the taxpayer on or after 9/23/88, for the startup expenses of establishing a child care program or constructing a child care facility in California, to be used primarily by the children of the taxpayer's employees.
- For taxable years beginning on or after 1/1/93, the cost paid or incurred by the taxpayer for startup expenses of establishing a child care program or constructing a child care facility in California to be used primarily by the children of employees of tenants leasing commercial or office space in a building owned by the taxpayer.
- The cost paid or incurred by the taxpayer on or after 9/23/88, for contributions to California child care information and referral services, including, but not limited to, those that identify local child care services where vacancies are available.

The amount of the credit cannot exceed $50,000. Refer to LR 93-2 for examples of the credit limitation.

No deduction is allowed for expenses paid or incurred for the taxable year which is equal to the amount of the credit allowed. Alternatively, the taxpayer may elect to take depreciation instead of a credit.

Child Care Contribution Credit

Taxpayer Employer

The credit was available to taxpayers who paid the cost for establishing a childcare program or constructing a childcare facility for tax years beginning on or after January 1, 1988, and before January 1, 2012.

Costs must have been paid on or after September 23, 1988.

Taxpayer with Tenant Employer

The credit was available to building owners for the startup expenses of establishing a childcare program or constructing a childcare facility to be used primarily by the children of employees of tenants leasing commercial or office space during tax years beginning on or after January 1, 1993, and before January 1, 2012.

The Employer Child Care Contribution Credit is allowed for a percentage of the cost paid or incurred for contribution to a qualified plan. Per R&TC §23167.5, for taxable years beginning on or after January 1, 1995, and before January 1, 2012, a credit is allowed for cost paid or incurred by the taxpayer for contributions to a qualified plan made on behalf of any qualified dependent of the taxpayer's qualified employee. The credit is 30 percent of the cost paid or incurred. The cost cannot exceed $360 for each qualified dependent. There is no comparable federal credit.

If an employer makes contributions to a qualified care plan and also collects fees from parents to support a child care facility owned and operated by the employer, no credit is allowed to the extent the sum of contributions and fees exceeds the total cost of providing care. You may require information about fees collected from parents of children served in the facility from taxpayers claiming credits under this section.

For tax years beginning on or after January 1, 2001, contributions do not include any amounts contributed to a qualified plan pursuant to a salary reduction agreement to provide benefits under a dependent care assistance plan.

Any unused credit may be carried over to the following year, and succeeding years if necessary, until the credit has been exhausted.

No deduction is allowed for that portion of expenses paid or incurred for the taxable year that is equal to the amount of the credit allowed under this section.

This credit cannot reduce

- Alternative minimum tax
- Minimum franchise tax
- Built-in gains tax (S corporations)
- Excess net passive income tax (S corporations)

Definitions

"Qualified care plan" means a plan providing qualified care.

"Qualified care" includes, but is not limited to, onsite service, center-based service, in-home care or home-provider care, and a dependent care center as defined by Section 21(b)(2)(D) of the Internal Revenue Code that is a specialized center with respect to short-term illnesses of an employee's dependents. "Qualified care" must be provided in this state under the authority of a license when required by California law.

"Contributions" include direct payments to child care programs or providers. "Contributions" do not include amounts contributed to a qualified care plan pursuant to a salary reduction agreement to provide benefits under a dependent care assistance program within the meaning of Section 129 of the Internal Revenue Code, as applicable, for purposes of Part 10 (commencing with Section 17001) and this part.

"Qualified employee" means any employee of the taxpayer who is performing services for the taxpayer in this state, within the meaning of R&TC §25133, during the period in which the qualified care is performed.

"Employee" includes an individual who is an employee within the meaning of IRC §401(c)(1) (relating to self-employed individuals).

"Qualified dependent" means any dependent of a qualified employee who is under the age of 12 years.

The credit is not available if the employee's dependent is in the care of a person who:

- Qualifies as a dependent or the employee or that employee's spouse.
- Is a son, stepson, or stepdaughter, of the employee and is under the age of 19 at the close of the tax year.

Prior Law

For taxable years beginning before January1, 1995, the credit was 50 percent of eligible costs with a maximum of $600 per qualified dependent under the age 15.

9050 Donated Agricultural Products Credit

Pursuant to R&TC §23608, for taxable years beginning on or after January 1, 1996, a credit is allowed in an amount equal to 50 percent of the transportation costs paid or incurred by the taxpayer in connection with the transportation of any agricultural product donated to a nonprofit organization.

The nonprofit organization is required to provide the taxpayer a certificate containing the donor's name, the type and quantity of product donated and the donee's name and address. You should request this certificate when examining the credit.

The taxpayer must reduce any deduction that would otherwise be allowed by the amount of the credit claimed. Since there is no comparable federal credit, a state adjustment may be required. (See MATM 6055.)

The credit may not reduce tax below the tentative minimum tax, but may be carried forward until exhausted.

Prior Law

For years 1989 through 1991 a credit is allowed for agricultural products, which are donated to nonprofit organizations. The credit is equal to 10% of inventory costs, defined under IRC §263A and includes farming operations.

9060 Economic Development Area Tax Credits

California currently has four types of Economic Development Areas (EDAs) that have related tax incentives:

- Enterprise Zones (EZs)
- Local Agency Military Base Recovery Areas (LAMBRAs)
- Manufacturing Enhancement Areas (MEAs)
- The Targeted Tax Area (TTA)

Taxpayers who conduct business activities within the boundaries of one of these areas or zones qualify for the hiring credit, sales and use tax credit and other tax incentives.

In prior years, special tax incentives were also available for taxpayers that conducted business activities within the boundaries of the former Los Angeles Revitalization Zone (LARZ), Program Areas and expired Enterprise Zones. The LARZ incentives applied to taxable years beginning on or after January 1, 1992, and before January 1, 1998. The Program Area incentives applied to taxable years beginning on or after January 1, 1985, and before January 1, 1997. For taxable years beginning on or after January 1, 1997, Program Areas were converted to EZs and are entitled to the benefits available to EZs. Over the years, a number of EZs have expired.

For more information about the EDA tax incentives, go to the EDA Manual.

9110 Low-Income Housing Credit

California allows a tax credit against tax for construction or rehabilitation of low-income housing in California. The credit is equal to 30 percent of amounts invested and is claimed over four years. To qualify for the state credit, a taxpayer must receive an allocation from the Tax Credit Allocation Committee, and the rents must be maintained at low-income levels for 30 years. This section discusses the areas where California law differs from federal. Whether or not the IRS has examined the federal credit, you should examine these areas.

- The low-income housing project must be located in California.
- The credit must be allocated and authorized by the California Tax Credit Allocation Committee (CTCAC).
- The CTCAC must have authorized a federal credit to the taxpayer or the taxpayer must qualify for the credit under IRC §42(h)(4)(B).)

The taxpayer is not required to attach form CTCAC 3521A, Certificate of Final Award of California Low-Income Housing Tax Credits, to the return. However, they must retain the certificate and make a copy available to you upon request.

California allows the credit to be claimed over a four-year period, not ten years as required under federal law. The applicable percentage of cost for computing the credit has changed over the years. In addition, the applicable percentage may depend on the highest federal rate and if the project is federally subsidized. You should refer to R&TC §23610.5 and IRC §42 when verifying the credit computation.

An additional credit may be claimed if the basis of a low-income housing building has increased since the CTCAC allocated the original credit. The CTCAC must authorize the additional credit.

California does not conform to the federal provision that allows the owner of a low-income housing unit occupied entirely by full-time students to qualify for the credit

There is no California provision similar to the federal provision that allows an election to claim 150 percent of the credit in the first year ending after October 24, 1990.

California requires a 30-year "compliance period", whereas the federal law only requires 15 years. The California law contains no provision, similar to the federal provision, for recapture of the credit if a project owner fails to comply with restrictions during the compliance period.

For tax years beginning on or after 1/1/2009 and before 1/1/2016, the credit shall be allocated to the partners of a partnership owning the project in accordance with the partnership agreement, regardless of how the federal low-income housing tax credit with respect to the project is allocated to the partners, or whether the allocation of the credit under the terms of the agreement has substantial economic effect, within the meaning of IRC §704(b)

Farmworker Housing

For taxable years beginning on or after January 1, 2009, the farmworker housing credit has been consolidated into the low-income housing tax credit.

Prior to 1/1/2008, unlike most credits, which may only be claimed by the entity incurring the costs, any portion of this credit may be assigned to one or more affiliates by election of the taxpayer. However, the affiliate must be 100% commonly owned. Once the election is made it is irrevocable for the year the credit is claimed, but the election may be changed in subsequent years. This credit assignment provision is effective for taxable years beginning on or after January 1, 1993. (R&TC §23610.5(q); formerly (r).)

The credit may reduce tax below the tentative minimum tax and may be carried forward until exhausted. The California credit remains in effect as long as the federal credit does. In 1993, the federal credit was extended indefinitely.

9120 Manufacturers' Investment Credit

To stimulate employment in California, the State Legislature enacted three provisions to alleviate the basic sales tax for manufacturing companies on purchases of manufacturing equipment. The Sales and Use Tax Code §6377 provides a partial sales tax exemption for new manufacturing companies equal to 5 percent of the 6 percent basic sales tax. As an alternative to the partial sales or use tax exemption, qualified taxpayers may claim a credit against tax on the California income or franchise tax return under R&TC §23649. Or, in lieu of claiming the sales tax exemption or the income of franchise tax credit, Sales & Use Tax Code §6902.2 allows taxpayers to file a claim for refund with the Board of Equalization for the sales and use tax paid. The refund is an amount equal to the income or franchise tax credit that would have been allowed to offset the current year tax liability. The refund may be claimed on or after the date the taxpayer would have been able to claim the credit on the income or franchise tax return.

Generally, a "qualified taxpayer" is allowed a manufacturers' investment credit (MIC) equal to 6 percent of the "qualified costs" paid or incurred for "qualified property" that is placed in service in California. Qualified Taxpayer, Qualified Property and Qualified Costs are the three requirements for claiming the MIC. All three must be met for the taxpayer to claim the credit. Each of the MIC qualification requirements is discussed below.

As stated in FTB Notice 2003-10, the California Legislative Counsel issued a written opinion dated June 17, 2003, that MIC statute has been repealed by its own terms and ceases to be operative as of January 1, 2004.

Qualified costs for the MIC are limited to those costs paid or incurred during the operative dates of the MIC statute. Therefore, all costs paid or incurred during the operative dates of the MIC statute for qualified property that is placed in service prior to January 1, 2004, may be qualified costs for purposes of the MIC. Conversely, for property that is placed in service on January 1, 2004, or thereafter, none of those costs will be qualified costs for the purpose of the MIC because a taxpayer is not eligible to claim the MIC until the property is placed in service in this state.

Definitions

Qualified Taxpayer

A "qualified taxpayer" for purposes of the MIC is any taxpayer that is engaged in an activity described in Division D (Manufacturing) of the Standard Industrial Classification (SIC) Manual, 1987 edition (SIC Code 2011- SIC Code 3999). A taxpayer with multiple business activities that are treated as "establishments" under the SIC Manual will be a qualified taxpayer if any one of its activities falls within SIC Code 2011- SIC Code 3999. In addition, for taxable years beginning on or after January 1, 1998, the definition of "qualified taxpayer" is expanded to include any taxpayer engaged in activities related to computer programming services or computer software design, SIC Code 7371 - SIC Code 7373.

The FTB Form 3535 instructions contain a condensed listing of manufacturing activities, which are classified under SIC Code 2011- SIC Code 3999. The SIC Manual describes and uses "establishments" to classify business activities into the various SIC codes. Examples of whether an activity constitutes an "establishment" can be found in CCR §23649-3. See the SIC Manual for a complete listing and the rules for determining classification of the SIC codes. The SIC Manual is available at http://www.osha.gov/cgi-bin/sic/sicser5.

In *Save Mart Supermarkets & Subsidiary*, 2002-SBE-002, February 6, 2002, the SBE addressed the 'qualified taxpayer' issue and held the activities of a full-service bakery and meat-processing department operating within a grocery store served to qualify the grocery store as a qualified taxpayer for the purposes of the MIC. In *Save Mart*, the taxpayer showed they were engaged in activities described in Division D (codes 2011 to 3999, plus codes 7371-7373 after January 1, 1998) of the SIC manual. In addition, in *Save Mart,* the SBE found the meat and bakery operations were more than a trifling or irrelevant segment of its overall operations. The qualifying activity must be a significant part of the overall operations of the business.

In 2005, the SBE again addressed the matter in an unpublished decision *Appeal of Safeway, Inc. The Vons Company Inc.* The Board again held for the taxpayer, finding *Safeway* was a qualified taxpayer, but further stated, " …we therefore observe that, although our *Save Mart* opinion serves as a precedent in other matters involving the same facts (i.e. other grocery stores with meat and bakery departments), its application under other facts (i.e., with respect to delicatessens and restaurants, among other things) has not been decided by this Board. As a result, if the qualified taxpayer issue is raised in other factual contexts, our analysis in *Save Mart* will certainly serve to guide us, but will not necessarily require a specific outcome, as we will need to examine the activities as alleged in light of the R&TC §23649 and *Save Mart*."

Based on the language in *Save Mart and Safeway,* you should continue to review the issue of a taxpayer being a qualified taxpayer in those situations when it is not obvious the taxpayer is a manufacturer. The analysis should give full weight and consideration to the holdings in *Save Mart* and *Safeway* and you should proceed forward according to the facts and circumstances of your case. The taxpayer must show they satisfy all applicable requirements (qualified taxpayer, with qualified costs for qualified property) in order to claim the MIC. When it is obvious a taxpayer is a manufacturer, the amount of time spent documenting that the taxpayer is a qualified taxpayer should be kept to a minimum. In some cases, you will determine the 'qualified taxpayer' test has been met under the *Save Mart and Safeway* decisions, and pursue only the qualified costs and qualified property tests. Regardless of the 'qualified taxpayer' position you may want to propose, your proposal should also fully address the qualified costs and qualified property areas related to any adjustment proposed.

AB 1040 (Ch. 605, Stats 1997) included language stating the legislature's intent to replace the references in §23649 from the SIC Manual to the new North American Industry Classification System (NAICS) Manual. The NAICS is being used for the Principal Business Activity Code Chart found in the California and federal tax booklets. This system replaces the use of the SIC for purposes of business classification. However, until R&TC §23649 is amended, the SIC Manual will continue to be used for purposes of the MIC.

Qualified Property

"Qualified property" refers to new or used IRC §1245(a) tangible personal property or off-the-shelf computer software upon which sales or use tax has been paid. Tangible personal property eligible for the MIC is generally considered to mean any tangible property except land and improvements, such as buildings, other inherently permanent structures, and their structural components. The determination of whether property is considered an inherently permanent structure is made in accordance with the provisions of IRC §1245(a), which describe an "inherently permanent structure" as one, which is affixed permanently and is incapable of being moved without significant damage.

In the appeal of *Bronco Wine Co*, 2002-SBE-006, November 13, 2002, the SBE addressed the 'qualified property' issue regarding "inherently permanent structures." The issue was whether the taxpayer's 215,000 gallon fermentation tanks or the concrete foundations constitute inherently permanent structures or tangible personal property. The SBE held that while the taxpayer's holding tanks qualified as qualified property, the concrete foundations did not. In arriving at their decision, the SBE relied heavily on the six-factors outlined in *Whiteco Industries, Inc., et al. v. Commissioner* (1975) 65 T.C. 664. The SBE concluded that the guiding principle when applying the six-factor Whiteco analysis should be whether the property at issue could reasonably be moved and placed back into productive use without damaging the property.

The six factors used in the Whiteco analysis are as follows:

- Is the property capable of being moved, and has it in fact been moved?
- Is the property designed or constructed to remain permanently in place?
- Are there circumstances that tend to show the expected or intended length of affixation, i.e., are there circumstances which show that the property may or will have to be moved?

- How substantial a job is removal of the property and how time-consuming is it? Is it "readily removable"?
- How much damage would the property sustain upon its removal?
- What is the manner of affixation of the property to the land?

Each of these factors alone is not decisive in determining whether the property is considered an "inherently permanent structure." Rather, as a whole, can the property reasonably be moved and placed back into productive use without damaging the property.

Because only tangible personal property qualifies for the credit, CCR §23649-5(b)(2) interprets the IRC §1245(a) requirement to mean that only property described in IRC §1245(a)(3)(A) qualifies for the MIC. One exception to the regulation's general application of the statutory IRC §1245(a) tangible personal property requirement applies to taxpayers engaged in a line of business classified under SIC Code 2911, Petroleum Refining. For this SIC code, qualified property also includes other tangible property defined in IRC §1245(a)(3)(B), such as outdoor permanent industrial structures. This property must be primarily used in petroleum refining for the production of "reformulated gasoline" or "oxygenated gasoline."

Another exception to the general IRC §1245(a) tangible personal property requirement is for special purpose buildings and foundations. Even though they are not IRC §1245(a) tangible personal property, special purpose buildings and foundations may also be considered qualified property, but only for taxpayers that are engaged in manufacturing activities that fall within certain SIC codes (generally related to computer or office equipment; electronic components; biotech or biopharmaceutical activities; space satellites and communications satellites and equipment; or semiconductor equipment). Rules regarding this exception are discussed in R&TC §23649(d)(3) and CCR §23649-5(c).

In the appeal of Baxter Healthcare Corporation (non citable), 2003-SBE, May 28, 2003 the SBE addressed the treatment of "special purpose buildings" and foundations under R&TC section 23649, subdivision (d)(4) in addition to the classification of "structural components" as tangible personal property under the "sole justification" test set forth in Treasury Regulation section 1.48-1(e)(2).

In the Baxter case, it was found that while certain divisions of the taxpayer apparently are qualified taxpayers for purposes of the MIC, the divisions were not engaged in manufacturing activities qualifying their facilities for treatment as special purpose buildings and foundations under R&TC section 23649, subdivision (d)(4). The taxpayer then attempted to establish the property at issue (HVAC systems) were tangible personal property, and qualified property for the MIC under the "sole justification" test set forth in Treasury Regulation section 1.48-1(e)(2).

Although a structural component, HVAC systems may be excluded from that categorization and deemed tangible personal property if the sole justification for installing the HVAC system is to meet essential temperature or humidity requirements.

Similarly in A.C. Monk Co., Inc. v. United States (4th Cir. 1982) 686 F.2d 1058, 1066, the court stated the relevant inquiry is "whether the structural components can be reasonably adapted in the present building to more general uses." If so, the systems are structural components of the building, not tangible personal property, and thus not qualified property.

You should ensure that their determinations are not based solely on the asset description, but upon a thorough understanding of the application, use and potential use of the asset.

Specifically excluded from the definition of qualified property is furniture, equipment used for warehousing or extraction purposes, inventory, or property used in administration, general management or marketing.

To be qualified property, at least 50 percent of the property's use must be in an activity that involves manufacturing, processing, refining, fabricating, recycling, research and development, or pollution control; or the maintenance, repairing, measuring or testing of any other qualified property. The business activity must fall within SIC Codes 2011-3999. Definitions of qualified activities are in CCR §23649-2. Also, examples of when property is treated as being primarily used in a qualified activity are in CCR §23649-5. For guidance on determining whether cement mixers for ready-mixed concrete are qualified property, see Legal Ruling 2001-4.

For taxable years beginning on or after January 1, 1998, qualified property also includes property consisting of computers and computer peripheral equipment (as defined in IRC §168(i)(2)(B)) used primarily by a qualified taxpayer to develop or manufacture prepackaged software or custom software. Qualified property for taxpayers involved in computer businesses described in SIC Codes 7371 - 7373 does not include any IRC §1245(a)(3)(A) tangible personal property other than computers and computer peripheral equipment (e.g., shrink-wrap machines, fork lifts, etc.). (R&TC § 23649(d)(2) as amended by AB 2798, Ch. 323, Stats. 1998.)

Qualified Costs

In general, the term "qualified costs" includes any capitalized costs paid or incurred by a qualified taxpayer for the construction, reconstruction or acquisition of qualified property on or after January 1, 1994. The costs must be properly includable in the taxpayer's depreciable basis of the property. Except for capitalized labor costs, qualified costs are an amount upon which California sales and use tax has been paid (directly or indirectly). For guidance on the use of California State Board of Equalization (SBE) sales and use tax audit results, see FTB Notice 2001-6. Examples of these requirements are in CCR §23649-4(a) - (c).

Capitalized labor costs for the construction or modification of qualified property may also qualify for the MIC, provided they meet the definition of "direct" labor costs under the federal uniform capitalization (UNICAP) rules. The UNICAP rules are in IRC §263A and the regulations thereunder. Examples of the capitalized labor cost requirements are in CCR §23649-4(d).

In the Appeal of California Steel Industries, Inc., (CSI) 2003-SBE-001-A, July 9, 2003, the SBE addressed the definition of capitalized labor costs paid to contractors and employees that are qualified costs for purposes of the Manufacturers' Investment Credit (MIC). The SBE held, labor costs paid to independent contractors should include all costs paid or incurred for services rendered in connection with the construction or modification of qualified property, including any overhead and profit attributable to such services. For the union labor costs, amounts include all of the component costs that comprise the total wage rates under master labor agreements. Non-labor costs are all other contract costs including, for example, materials, equipment purchases and/or rentals, small tools and consumables, and all other non-service charges and reimbursable costs, including overhead and profit attributable to such non-labor costs. If, however, a taxpayer can verify payment of sales or use tax on these items, then these non-labor costs may qualify under the general rule of section 23649, subdivision (b). In addition, the decision affirmed that taxpayers using employee labor for the construction of MIC assets may only claim direct costs of labor as defined in Internal Revenue Code §263A and California Code of Regulations §§23649-2(b) and 23649-4(d) as qualified costs for the MIC.

For more guidance on the treatment of capitalized labor, see the SBE's decision in *Appeal of California Steel Industries, Inc.,* 2003-SBE-OO1-A, July 9, 2003.

A qualified taxpayer who leases qualified property may claim the MIC as long as the lessor paid California sales or use tax when it acquired the property. The lessor may not claim the MIC. The normal "qualified cost" rules do not apply to lessees. Instead, under an operating (or true) lease, the lessee may generally claim the MIC based upon the purchase price amount on which the lessor paid sales or use tax, plus any capitalized labor costs related to the lessor's construction or modification of the property. If the property is later re-leased to another lessee, the second lessee's qualified costs must be reduced by the costs used to compute the prior lessee's MIC. The general requirement that qualified costs must be chargeable to the qualified taxpayer's capital account does not apply to a lessee's rental payments under an operating (or true) lease arrangement.

In the case of an operating (or true) lease, the lessor must provide the lessee with a written statement within 45 days after the close of the lessee's taxable year, containing the amount of the lessor's qualified costs (i.e., the amount of such cost upon which the lessor has paid California sales or use tax).

If the lease is a finance (or capital) lease for sales and use tax purposes, then the rules applicable to an acquisition will generally apply in calculating the qualified costs of the lessee. These general rules are subject to a few exceptions and refinements depending upon the type of lease and how the transaction is structured. For more information regarding leased property, see R&TC §23649(f) and CCR §23649-6.

The MIC is claimed on FTB Form 3535, Manufacturers' Investment Credit. The taxpayer is required to complete and attach this form to the return. The FTB Form 3535 contains information such as the description of the property, the qualifying activity, the primary use SIC code, whether or not the property is leased, the date placed in service, the sales or use tax paid, the property cost, any included capitalized direct labor costs, etc.

The first year the MIC may be taken is the qualified taxpayer's first taxable year beginning on or after January 1, 1995. In addition to costs actually paid or incurred during that first taxable year beginning on or after January 1, 1995, qualified costs paid or incurred on or after January 1, 1994, may also be claimed in that first credit year. For example, assume a taxpayer with a June 30 year-end. The first taxable year this taxpayer can claim the MIC is its year ended June 30, 1996, the first year beginning after January 1, 1995. To determine its credit, the taxpayer may include all qualified costs incurred from January 1, 1994, through June 30, 1996. For qualified taxpayers engaged in those lines of business under SIC Codes 7371 - 7373, substitute "the first taxable year beginning on or after January 1, 1998," for "January 1, 1994." Rules with respect to costs incurred pursuant to binding contracts in existence prior to January 1, 1994, are covered in CCR §23649-4(e).

The total cost of property eligible for the credit must be reduced by the amount of sales or use tax paid on the property. However, unlike many credits, the basis of qualified property for which the MIC is claimed is not required to be reduced by the amount of the credit.

There is no annual limit on the MIC. However, the amount of the credit that a taxpayer can use may be limited. The credit may not reduce the minimum franchise tax imposed on corporations and certain other entities. The MIC may not reduce the built-in gains tax or the excess net passive income tax imposed on some S corporations; or the limited liability company (LLC) gross receipts fee. Also, the credit may not reduce alternative minimum tax, but may reduce the "regular" California tax below the tentative minimum tax. If a taxpayer takes a Los Angeles Revitalization Zone Credit (R&TC

§23612.6) with respect to the same qualified property, the taxpayer cannot take the MIC for that same item.

Generally, the credit can be carried forward for eight years. Small businesses, defined in R&TC §23649(e)(10), can carry the credit forward for ten years. The length of the credit carryover period for a credit generated by a pass-through entity (S corporation, partnership, LLC taxed as a partnership, etc.) is determined at the entity level. For more information regarding the MIC carryforward provisions, see CCR §23649-9.

If the property upon which the credit is claimed is disposed of within one year or less from the date the property was first placed in service in California, the credit must be recaptured pursuant to R&TC §23649(g). Disposition includes removal of the property from California, use of the property primarily in a nonqualified activity, and transfer or sale of the property to an unrelated party, defined by IRC §267, IRC §318 or IRC §707. For more information regarding the recapture provisions, see CCR §23649-8.

9140 Research Expenses Credit

IRC §41 provides for a federal research tax credit equal to 20 percent of the amount by which a taxpayer's qualified research expenditures for a taxable year exceeded its base amount for that year, or for basic research payments. California allows a similar credit against tax for the amounts paid or incurred for research conducted in California. Generally, the credit is allowed in accordance with IRC §41, modified for California by R&TC §23609. There are several other federal and state differences, as well as several law changes that have been made periodically. Therefore, be familiar with the California provisions for the year under audit. The research credit for both existing companies and "start-up" companies is claimed on FTB Form 3523.

California's credit for increasing research activities came into existence under R&TC §23609 for corporations in 1988. The California research credit rates have changed since conformity. For taxable years beginning on or after January 1, 2000, the California credit is 15 percent of the excess of qualified research expenses for the taxable year over the base period research expense amount, plus 24 percent of the basic research payments for corporations. See the table below for rates for the year(s) you are auditing.

Corporations may elect to reduce the regular credit to avoid having to make a state adjustment to income for the amount of the credit. According to IRC §280C(c) & R&TC §24440, deductions claimed for research activities must be reduced by the amount of the current year's research credit. However, if the taxpayer makes a timely election, by the due date for filing the return including extensions, to take the reduced credit, then the state adjustment to income is not required. If the taxpayer does not elect the reduced credit, it must add-back the amount of the credit created for the year, regardless of how much of it is actually used to reduce the current year tax liability. Be aware that taxpayers may have a different election for state and federal purposes and they can change the election from year to year, but the election is irrevocable. If the taxpayer does not elect the reduced credit for federal purposes, there should also be a state adjustment to eliminate the IRC §280C(c) add-back. Similar to federal, the election may not be made on an amended return.

For taxable years beginning on or after January 1, 1997, corporations may elect to use the "Alternative Incremental Credit" rather than the regular credit. The alternative incremental credit allows a smaller 3-tiered fixed-base percentage and a reduced 3-tiered credit rate. To use the alternative incremental credit, the taxpayer must make an election for any taxable year beginning on or after January 1, 1997 and cannot change to the regular method unless it receives consent from FTB to revoke the election.[1]

For taxable years beginning on or after December 31, 2006 the IRS introduced a third method to compute the research credit, commonly referred to as the "Alternative Simplified Credit". In essence, Section 41(c)(5)(A)[2] provided a credit equal to 12 percent of QREs in excess of 50 percent of the average QREs for the three taxable years preceding the taxable year. California has not adopted this method and therefore taxpayers should not use this method in calculating the California research credit.

QUALIFIED RESEARCH ACTIVITY

Under IRC §41(d)(1), the following four tests must be met for R&D expenditures to be considered qualified research expenses:

- The expenditures must qualify for a deduction under IRC §174,
- The expenditures must have been made to discover information that is technological in nature,
- The purpose of the research is intended to be useful in the development of a new or improved business component of the taxpayer, and
- Substantially all of the activities constitute elements of a process of experimentation that relates to a new or improved function, performance, or reliability or quality.

In reference to the above, be aware that there is no formal "discovery test" or "technological information test" to determine if a taxpayer meets the requirement under IRC §41(d)(1)(B)(i). Research is undertaken for the purpose of discovering information if it is intended to eliminate uncertainty concerning the development or improvement of a business component, and technological in nature if the process of experimentation used to discover such information fundamentally relies on principles of the physical or biological sciences, engineering, or computer science. This applies to all years including tax years beginning before December 31, 2003 (effective date of the regulation).

Be mindful not to deny the research credit based on the "discovery test," nor should you refer to the "discovery test" in determining if the taxpayer met the requirements of qualified research under IRC §41. Use the proper test under "technological information" to determine if the taxpayer meets the requirement of IRC §41(d)(1)(B)(i).

A better approach would be to focus on the process of experimentation and review the taxpayer's documentation of the experimentation process. Treasury Regulation section 1.41-4(a)(5)(i) defines the "process of experimentation" in relevant part as "a process designed to evaluate one or more alternatives to achieve a result where the capability or the method of achieving that result, or the appropriate design of that result, is uncertain as of the beginning of the taxpayer's research activities.

When considering any adjustments to qualified research expenses, document the audit steps taken to gain assurance that the taxpayer engaged in a qualified activity (IRC §41(d)) in California. Once obtained, staff can proceed to a review of QREs. To gain this assurance, obtain sufficient knowledge of the taxpayer, their business, and the claimed research activities to explain whether the taxpayer engaged in qualified research activities.

Depending on the situation, a limited analysis of qualified activity can be performed. Yet some level of discussion is required to support a decision relating to a limited analysis of a qualified activity. This limited analysis must document the support relied upon in concluding that the taxpayer under review was engaged in qualified research activities. We encourage staff to collaborate with SME's from the specialized consulting group and Task Force.

Situations that may warrant limited analysis of qualified activity include:

- Following Federal or prior State examinations
- Audits of federal/state differences such as sourcing qualified expenses to California, gross receipts definition, and computational adjustments.
- Industry Experience.
- Excluded activities under IRC §41(d)(3) & (4) (Funded Research, Social Science, Style, etc.)

QUALIFIED RESEARCH EXPENSES

A review of the costs included in the qualified research expense should be considered. The taxpayer must have incurred the costs while conducting research in California for a qualified activity. Qualified research expense equals the sum of in-house research expenses and contract research expenses (IRC §41(b)(1)). In-house research expenses include compensation, supplies, and amounts paid to another person for the right to use computers in the conduct of qualified research.

IN-HOUSE RESEARCH EXPENSES

COMPENSATION

For purposes of computing this credit, compensation must be directly related to the research activities and paid by the taxpayer (IRC §41(b)(2)). This may include direct supervision, direct support or direct performance of qualified research. An allocation of the purchasing or receiving departments' wages does not qualify because they are indirect costs. Items, which are considered compensation for purposes of determining the credit, include, but are not limited to, salaries, wages and taxable income from non-qualifying stock plans or disqualifying dispositions of incentive stock options (see *Apple Computer v. IRS*, 98 TC 232; and *Sun Microsystems, Inc.,* TC Memo 1995-69, 69 CCH TCM 1884). Deferred compensation and fringe benefits (such as health benefits) are not qualifying expenditures. Information to make the above determinations can be found in employees' W-2 records, job descriptions, duty statements, employee evaluations, etc.

SUPPLIES

Supplies include all tangible property that is consumed directly by the research activity or that goes into the prototype. The supplies must be used in conducting qualified research. Supplies mean any tangible property, other than land or improvements to land, and property of a character subject to the allowance for depreciation (IRC §41(b)(2)). In some cases, the costs attributable to the construction of molds and other special tooling may not be deductible as research and experimental expenditures under IRC §174 because the costs are for the component material and labor associated with the manufacturing of products sold by the taxpayer to its customers.

Examples of supplies that qualify are those used by a laboratory scientist in experimentation, those used by a laboratory assistant in entering research data into a computer, and those used by a machinist in the fabrication of a part for an experimental model. (See Treas. Reg. §1.41 for more examples.)

Generally, utilities (phone and electricity), small tools, and allocations of the total shipping cost are not qualifying supply expenses. Contract expenses in the cost of supplies are not permissible qualifying supply expenses.

CONTRACT RESEARCH EXPENSES

Contract research means 65 percent of amounts paid to any person (excluding taxpayer's employees) to perform qualified research (IRC §41(b)(3)) (For taxable years beginning on or after January 1, 1997, 75 percent of amounts paid to a qualified research consortium qualify). The outside consultant must perform the research in

California. Such an expense is only qualified to the extent that it is paid or incurred under an agreement that:

(1) is entered into before the performance of the qualified research;

(2) provides that research be performed on behalf of the taxpayer, and

(3) requires the taxpayer to bear the expense even if the research is not successful.

Funding Exclusion

The term "qualified research" shall not include any research to the extent funded by any grant, contract, or otherwise by another person (or governmental entity).

In order to determine if the contractor's research expenditures are "funded", the following questions must both be true:

- Is payment for the contractor's research activities "contingent upon the success of the research" under Treasury Regulation section 1.41-4A(d)(1)?
- Does the contractor retain "substantial rights" in the results of the research activities within the meaning of Treasury Regulation section 1.41-4A(d)(2)?

If the contractor performing research for another person does not retain substantial rights in the research, and if the research payments are contingent on the contractor's success, neither the contractor nor the person (taxpayer) paying for the research is eligible to claim the credit.

If a taxpayer's activities are determined to be funded by its customers, then those activities can be excluded before applying the resource intensive four-part test.

We recommend addressing the Funding Issue early on in the audit. If your taxpayer is a contractor or provides services under contract, there is potential for a funding audit. You can contact an R&D Subject Matter Expert (SME) to help you identify and understand the issue.

INTERNAL-USE SOFTWARE

Software developed by the taxpayer for its own internal use qualifies for the credit if it is used in an activity that constitutes qualified research or is used in a production process developed through activities constituting qualified research (IRC §41(d)(4)(E)). Other software created for internal use is not eligible for the credit unless it meets the four tests for qualified research (outlined above) plus the following three tests:

- The software must be innovative,
- Its development must involve significant economic risk, and
- It cannot be commercially available for use by the taxpayer.

There are two significant federal court cases concerning qualified activities with regard to internally developed software that you should be aware of:

- *United Stationers, Inc. v. United States* (7th Cir. 1998) 163 F.3d 440 - Credit was disallowed based on lack of technological nature and no experimentation process.

- *Norwest Corp. v. Comm'r* (1998) 110 T.C. 454 - Seven of eight internally developed software projects were not considered qualified because the sampled projects involved a "cookbook" approach to development that did not involve technical risk. This case includes a review of the seven tests discussed above.

The final regulations §1.41-4 (c)(6) (T.D. 9786), published in the *Federal Register* on October 4, 2016, clarify that the internal use software rules do not apply to:

(1) software developed for use in an activity that constitutes qualified research;

(2) software developed for use in a production process to which the requirements of *section 41(d)(1)* are met; and

(3) a new or improved package of software and hardware developed together by the taxpayer as a single product. Accordingly, under the final regs, the high threshold of innovation test applies only to the software developed for use in general and administrative functions that facilitate or support the conduct of the taxpayer's trade or business and to dual function software.

The final regulations apply to tax years beginning on or after Oct. 4, 2016, the date they were published in the *Federal Register*. However, the IRS will not challenge any return that is consistent with the regulations for tax years ending on or after Jan. 20, 2015, and beginning before Oct. 4, 2016. (Regulation §1.41-4(e)).

Prior to the final Regulations:

For taxable years ending before January 20, 2015, taxpayers may choose to follow either all of §1.41-4(c)(6) as contained in 26 CFR part 1 (revised as of April 1, 2003) and IRB 2001-5 (see www.irs.gov/pub/irs-irbs/irb01-05.pdf) or all of §1.41-4(c)(6) as contained in IRB 2002-4 (see www.irs.gov/pub/irs-irbs/irb02-04.pdf). (Regulation section 1.41-4(e)).

GROSS RECEIPTS FOR CALIFORNIA PURPOSES

R&TC §23609(h)(3) defines the term gross receipts for purposes of computing the California research credit for taxable years beginning on or after January 1, 1993. When computing the fixed-base percentage and average annual gross receipts for California credit purposes, only California gross receipts are used in the computation. California gross receipts should 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 that is delivered or shipped to a purchaser in California. This includes sales to the U.S. government, which are delivered in California. Throwback sales and receipts from services, rents, operating leases and interest are excluded from the computation.

California's definition of gross receipts can result in some taxpayer's having "zero gross receipts." Legal guidance was issued regarding this situation that allows such an entity to still claim the credit (FTB Legal Guidance 2012-03-01).

A taxpayer with "zero gross receipts" for California purposes may only claim the regular incremental credit as a start-up company. This result creates a situation whereby a taxpayer with "zero gross receipts" will not be subject to an incremental requirement and will be allowed the maximum credit base on 50% of its QREs.

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.

Following Federal/ Best Practices

One of our Best Audit Practices is following federal audits so we would be consistent with IRS audit practices and to avoid duplication of effort. However, it may sometimes be unclear what exactly the IRS examined in their audit and how that relates to research performed in California.

REMEMBER TO REQUEST A BMF/IMF FOR ALL YEARS, EVEN THOSE OUTSIDE THE AUDIT CYCLE, THROUGHOUT THE AUDIT. We need to be proactive and perform our due diligence to see if the IRS (or FTB) has examined the taxpayer's qualified research activities, and qualified research expenses.

There may be a situation where we will need to conduct our own examination to determine that the activities in California qualify for the credit claimed.

The following are some *Tax News* articles related to the California research credit and following federal audits:

Feb 2018 [Recent IRS Directive for the California Research Credit]
May 2015 Following a Federal Determination for Research Credit Cases
Nov 2014 Following Federal in a Research Credit Case

MEMBERS OF A CONTROLLED GROUP:

California conforms to the federal rules for aggregation of expenses and allocating this credit among members of a controlled group (IRC §41(f)). To determine the amount of the credit, all members of the same controlled group of corporations are treated as a single taxpayer. The group credit is computed by applying all of the section 41 computational rules on an aggregate basis. All members of a controlled group must use the same method of computation. For California purposes, this includes the regular method, as described in section 41(a)(1) or the alternative incremental credit (AIRC) method as described in former section 41(c)(4) (prior to renumbering in 2018). Keep in mind that California does not conform to the Alternative Simplified Credit (ASC), R&TC §23609(h)(4), nor does it conform to the special rule that treats a consolidated group as a single member of the controlled group (Treasury Regulation §1.41-6(d)).

Treasury Regulation §1.41-6(a) provides a bright line ownership test for groups of organizations under common control. In general, taxpayers that are part of parent/subsidiary groups and brother/sister groups, as defined under Treasury Regulation §1.52-1(b)-(g), will be considered members of the same controlled group for R&D Credit purposes. Treasury Regulation §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.

In the case of a corporation that is part of a brother/sister group, a controlling interest is defined as at least 80 percent of the combined voting power of all classes of stock or at least 80 percent of the total value of shares of all classes of stock held by the same five or fewer persons.

Allocation of the Credit

California conforms to the federal rules for allocating the research credit among members of a controlled group (IRC §41(f)). To determine the amount of the credit, all members of the same controlled group of corporations are treated as a single taxpayer.

You must aggregate all components comprising the R&D Credit calculation. Depending on the taxable year (TY), there could be several options in allocating the credit. For TYs ending after December 31, 2014, California conformed to the new federal allocation method (the federal method was changed for TYs beginning in 2012, but we did not conform until 2015). This method allocates the total or "group" R&D Credit to the members based on their proportionate share of research expenses (this method is referred to as the "expenditure method" and is computed under Method 2 in our PASS schedules).

For TYs ending May 24, 2005 through December 31, 2014, the total or "group" R&D Credit is allocated to the members of the controlled group based upon their proportionate share of their stand-alone credit over the total of 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 (as of 6/30/2018, the PASS schedules do not compute this method; schedules to compute this method can be found on the R&D web page).

For TYs beginning prior to May 24, 2005 there were two methods allowed at different times. The current method, which has been referred to as the "Expenditure Method," was previously determined to be incorrect. Proposed Regulation §1.41-8 (issued January 4, 2000 and subsequently re-numbered to 1.41-6) clarified the correct method, and referred to it as the "Incremental Method." Under the "Incremental Method" the group research credit is allocated to each member based on the ratio that the member's increase in its qualified research expenses over its base amount bears to the sum of each member's increase in qualified research expenses over the base amounts.

Taxpayers were allowed to compute the credit using either method for taxable years ending prior to January 4, 2000. For taxable years ending on or after January 4, 2000, taxpayers were instructed to follow the incremental method as prescribed in the proposed federal regulation. The PASS Template for the R&D Credit contains both methods for allocating the credit among group members. Method #1 in the PASS Template follows the "Incremental Method", which was the preferred method from January 4, 2000 through May 24, 2005, while Method #2 follows the "Expenditure Method", which is the new method, for California purposes, as of taxable years beginning in 2015.

Credit Limitation (IRC §41(g)/R&TC §23036(i))

The amount of the research credit passed through to an individual on FTB Schedules K-1 (100S, 541, 565 or 568) may be limited per IRC §41(g) and related regulations. For more information, refer to the instructions for FTB 3523 for the year under audit. Be aware that this limitation is only on individuals and does not apply to corporations.

There is a special rule for Single Member LLCs (SMLLCs), treated as a "disregarded entity," that generate credits. CR&TC §23036(i) limits the amount of credit that the single member can utilize in a given year. The limitation is the amount of tax attributable to the "disregarded entity" even though the tax liability is only due to the single member.

Treatment of SMLLCs can pose many complicated and sometimes un-intentioned results. Many issues can impact the usage and assignment of credits by the single member utilized in a given year. You can contact an R&D Subject Matter Expert (SME) to help you identify and understand the issue.

Credit Assignment

R&TC §23663 allows the assignment of credit.

Corporations can assign credits to other members of their combined reporting group for tax years beginning on or after July 1, 2008. For more information, go to form FTB 3544, **Election to Assign Credit Within Combined Reporting Group**. A credit assigned may be only be applied against the tax of the eligible assignee in a tax year beginning on or after January 1, 2010.

For further details regarding credit assignment, see MATM section 9015.

Closing Agreements

There may be times when a closing agreement is an efficient way to close out a research credit issue. Taxpayers can request a closing agreement at any time in the audit process. All of the material, relevant facts relating to the transaction or issue in dispute must have been determined before the FTB will enter into a closing agreement.

Closing agreements are formal written agreements between FTB and the taxpayer to conclusively establish some aspect of a tax liability. Entering into a closing agreement is discretionary by the Department. Once signed, the closing agreement closes the issue(s) specified in the agreement; and in exchange, the taxpayer forgoes protest, appeal, litigation or settlement on the issue(s).

If a taxpayer requests a closing agreement for the research credit an auditor should contact the TRS SME for the Research Credit and consider the following:

- Auditors should be aware of the difference between a closing agreement and a settlement.
- The TRS Reviewer assists the auditor and supervisor as follows:
  - Evaluate the case to determine if a closing agreement is a viable option.
  - Provide assistance with obtaining all necessary information from the taxpayer.
  - Assist auditor to prepare closing agreement issue for legal.

  - Act as a liaison with legal to evaluate case and assign an attorney.
- Legal will prepare and finalize the closing agreement.

For more information: Refer to the https://www.ftb.ca.gov/tax-pros/law/closing-agreement/index.html.

Alternative Minimum Tax

The credit cannot be used to reduce Alternative Minimum Tax. However, for taxable years beginning on or after January 1, 1989, R&TC §23036 was revised to allow the research credit to reduce the regular tax below the tentative minimum tax. If the credit is not used in the current year, it may be carried over to subsequent years until it is exhausted.

As of 2016, the IRS allows eligible small businesses to offset AMT and a certain amount of payroll tax. California does not conform to these provisions.

Termination Date

R&TC §23609 does not provide a termination date for the California research credit. However, be aware that IRC §41 incorporates a termination date, which changes often. Also, note that the federal credit has a lapse period. No federal credit was allowed for expenses incurred between June 30, 1995 and July 1, 1996. This may explain why the federal credit in those years may be smaller than the California credit. The termination dates provided under federal law did not apply for California purposes.

California Research Credit Rates

California did not conform to the federal fixed-base period computation until January 1, 1993. For years prior to 1993, California used a three-year moving average to compute the base amount. If needed, refer to the prior law and forms for those years.

This table shows the changes in research credit rates:

Tax Years Beginning	Qualified Research	Basic Research	alternative incremental
1987-1996	8%	12%	N/A
1997	11%	24%	1.65%, 2.20%, 2.75%
1998	11%	24%	1.32%, 1.76%, 2.20%
1999	12%	24%	1.32%, 1.76%, 2.20%
2000 and later	15%	24%	1.49%, 1.98%, 2.48%

R&D Website

For more information related to the Research Expenses Tax Credit, the statute, regulations, rulings, forms, etc., visit the R&D website.

[1] The California AIRC is a separate election and must follow the rules under §23609(h) including getting permission to revoke the election. For federal purposes, taxpayers may automatically revoke a federal election, but that automatic revocation is not allowed for the California election. TRSB keeps records of taxpayers' requests to revoke the AIRC election.

[2] In 2018, Section 41(c)(5) was renumbered to 41(c)(4), which was the AIRC section that was repealed as of 2009.

9150 California Motion Picture and Television Production Credit

R&TC §17053.85, R&TC §17053.95, R&TC §23685 and R&TC § 23695 allow a tax credit based on expenditures incurred for film and television productions. The taxpayer may use the credit to offset California income and franchise tax liabilities and/or elect to apply the credit against sales and use tax. Credits applied to the franchise or income tax liability are not refundable. Tax credits attributable to an independent film may be sold to an unrelated party. Qualified taxpayers may elect to assign their credit to one or more affiliated corporations. See R&TC §23685 and R&TC § 23695 for details. This credit first became available for use beginning January 1, 2011. This is the "old credit". This "old credit" ceased to be operative on July 1, 2016. Effective from January 1, 2016 an expanded version of the credit, known as the "new credit" became available. This "new credit" will continue until fiscal year 2019/2020.

The California Film Commission (CFC) administers California's motion picture credit. The CFC will allocate the tax credits to qualified taxpayers on or after July 1, 2009 and before July 1, 2020. The CFC issues a credit certificate (CFC Schedule M) to the qualified taxpayer once the qualified motion picture is completed and the qualified expenditures are verified. The amount of credit shown on the certificate is the allowed credit.

The CFC provides FTB with a list of qualified taxpayers and the amount of credits allocated to each taxpayer. Contact TRS to obtain information from the list to validate the credit.

The credit is a percentage of qualified expenditures paid or incurred by the qualified taxpayer for the qualified motion picture or television series.

- 20 percent of qualified expenditures attributable to production of a qualified motion picture in California:
  - Feature film ($1 million minimum production budget and up to $100 million in qualified expenditures). The "old credit" had a $75 million maximum production budget limitation.
  - Movie of the week or miniseries ($500,000 minimum production budget)
  - New television series ($1 million minimum budget; longer than 40 minutes running time exclusive of commercials)
  - Television series that relocated to California (second or subsequent years of receiving the credit)
- 25 percent of qualified expenditures attributable a television series or independent film:
  - A television series that relocated to California in its first year of receiving the credit
  - An independent film

This credit applies to the following entities:

- Individuals
- Estates and trusts
- C corporations
- S corporations
- General partnerships
- Limited partnerships
- Limited liability partnerships
- Limited liability companies treated as partnerships
- Limited liability companies treated as corporations
- Exempt organizations with unrelated business income

Selling the Credit

A qualified taxpayer may sell a credit, attributable to an independent film, to an unrelated party once they receive the certificate from the CFC. For this purpose, a related party is one that would be treated as a related party under Internal Revenue Code sections 267, 318, or 707. The credit may only be sold once and may not be resold or reassigned. The credit may not be sold to multiple parties. The qualified taxpayer must notify FTB of the sale by filing form FTB 3551, Sale of Credit Attributable to an Independent Film.

Independent Films

R&TC §17053.85(c)(1), R&TC §17053.95(c)(1) R&TC §23685(c)(3)(A) and R&TC §23695(c)(3)(A) allow qualified taxpayers to sell a credit attributable to an independent film to an unrelated party.

To qualify as an independent film, the film and producing company must meet the following criteria:

- The film must have a minimum budget of one million dollars ($1,000,000). Though not a requirement for the new credit, the old credit had a maximum budget limitation of ten million dollars ($10,000,000).
- The film must be produced by a company that is not publicly traded.
- Publicly traded companies cannot directly or indirectly own more than 25 percent of the company producing the film.

Assigning the Credit

Under R&TC §23685(c) and R&TC §23695(c) a qualified taxpayer may elect to assign a credit to an affiliated corporation. An affiliated corporation includes a corporation:

- That owns directly or indirectly, 100 percent of the assignor's voting common stock, or
- In which the assignor owns, directly or indirectly, 100 percent of the voting common stock or
- That is wholly owned by a corporation or an individual owning 100 percent of the voting common stock of the assignor or
- That is a stapled entity as defined in R&TC §25105

The credit can be assigned to one or more affiliates. Qualified taxpayers may elect to split the credit and apply a portion to their income or franchise tax liability and a portion to their sales and use tax. Once made, the election is irrevocable. Only credits generated by the entity or received from a pass-through may be assigned. Credits received as an assignment or purchased by the entity may not be re-assigned. The taxpayer may only assign the credit which is in excess of their current year's income or franchise tax liability.

The limitations imposed by R&TC §23036(i) with respect to credits generated by a Single Member Limited Liability Company (SMLLC) do not apply to sale or assignment of this credit.

This credit may also be assigned under the credit assignment rules of R&TC §23663. See MATM 9015 for additional information.

Reporting and Using the Credit

Taxpayers must report the allocation, purchase, sale, use, assignment and application of the credit to sales and use tax by filing form FTB 3541, California Motion Picture and

Television Production Credit. This must be filed with the annual tax return. Taxpayers must file separate forms when using the "old" and the "new" credits.

Under R&TC §23036(d)(1)(R) and R&TC §23036(d)(1)(T) corporations can use the credit to reduce the regular tax below the tentative minimum tax.

Carryover

In the case where the credit allowed exceeds the "net tax", the unused credit (both the "old" and "new" credit) may be carried over for six years after the credit was generated. The credit cannot be carried back to any prior year. The carryover from the "old credit" can be used simultaneously with the "new credit" until the credit expires six years after the generation of the "old credit".

Applying Against Sales & Use Tax

Taxpayers may make an irrevocable election with the Board of Equalization (BOE) to apply the credit against qualified sales and use taxes. The credit is refundable and any excess can be carried forward and applied to the sales and use taxes for five years.

Qualified Taxpayer

A qualified taxpayer is a taxpayer who has paid or incurred qualified expenditures and has been issued a credit certificate by the CFC. In the case of pass-through entities, determination of a qualified taxpayer is made at the entity level. The credit is not allowed to be used by the pass-through entity, but is passed through to the partners, members or shareholders. (For example, an S corporation cannot apply 1/3 of the credit toward its tax.)

Qualified Expenditures

Qualified Expenditures are amounts paid or incurred for the purchase or lease of tangible personal property used within California and qualified wages for services performed in California in the production of a qualified motion picture.

Qualified Motion Picture

Qualified motion picture is a motion picture produced for distribution to the general public and is one of the following:

- A feature film with a minimum production budget of $1 million. The "old credit" had a maximum budget limitation of $75 million
- A television series produced in California with a minimum production budget of $1 million
- A movie of the week or miniseries with a minimum production budget of $500,000

- An independent film
- A television series that relocates to California A pilot for a new television series that is produced in California with a minimum production budget of §1 million (no such provision in the "old credit")

Auditing the Credit

Since CFC is administering the credit, you do not need to validate the expense. You should confirm the following:

- CFC granted the credit by issuing a credit certificate. This is validated by contacting TRS to check the Motion Picture Credit list obtained from CFC.
- Check the Motion Picture Credit list to validate if taxpayer has already used the credit, elected to use the credit against their sales and use tax with BOE, or sold the credit.
- If credit is sold or assigned and both taxpayers are claiming the credit against their tax, you may deny the credit of either taxpayer, so long as the statute of limitations upon the assessment remains open.

Additional Information

To learn more about applying for and claiming the tax credits, refer to the following websites:

- Franchise Tax Board – California Motion Picture and Television Credit – Information on claiming the tax credits against franchise or income tax.
- *** **** ****** ******* *** *********** ********** ******
- California Film Commission (CFC) - The CFC is administering the tax credit program.
- California Department of Tax and Fee Administration (CDTFA) - Information on claiming the tax credits against sales and use tax liabilities.

9160 New Jobs Credit

For tax years beginning on or after January 1, 2014, this credit can no longer be generated.

For tax years beginning on or after January 1, 2009 and before January 1, 2014, qualified employers were allowed a credit of up to $3,000 for each additional qualified full-time employee they hired during the year.

Prior Law

A new tax credit of up to $3,000 for each additional full-time employee hired is available to small businesses with 20 or less employees beginning January 1, 2009. The credit is prorated on an annual full-time equivalent basis for employees employed less than a full year.

- The credit is not subject to the 50 percent limitation for business credits.
- The total amount of credit available to be claimed by all taxpayers is capped at $400 million.
- The credit must be claimed on a timely filed original return received by the Franchise Tax Board on or before a cut-off date specified by the Franchise Tax Board.
- Taxpayers claiming the credit on an original return received by the Franchise Tax Board after the cut-off date is met will be notified that the credit has been denied.

To Qualify

- An employer will qualify for the credit if:
    - Each qualified full-time hourly employee is paid wages for not less than an average of 35 hours per week.
    - Each qualified full-time employee that is a salaried employee was paid compensation during the year for full-time employment within the meaning of Section 515 of the Labor Code.
    - On the last day of the preceding taxable year, they employed a total of 20 or fewer employees.
    - There is a net increase in qualified full-time employees compared to the number of full-time employees employed in the preceding taxable year. For taxpayers who first commence doing business in California during the taxable year, the number of qualified full-time employees employed in the preceding year would generally be zero, unless certain special rules apply.

Exceptions

- An employer may not claim the credit for those employees who are any of the following:
    - Certified as a qualified employee in an enterprise zone or targeted tax area.
    - Certified as a qualified disadvantaged individual in a manufacturing enhancement area.
    - Certified as a qualified disadvantaged individual or qualified displaced employee in a local agency military base recovery area.

- An employee whose wages are included in calculating any other credit allowed.

The credit is claimed using FTB Form 3527.

9170 CALIFORNIA COMPETES TAX CREDIT (CCTC)

The California Competes Tax Credit is an income tax credit available to businesses that want to come or stay and grow in California. Tax credit agreements are negotiated by California Governor's Office of Business and Economic Development (GO-Biz) and approved by a statutorily created California Competes Tax Credit Committee. Each agreement is for five taxable years and each year has an allocated amount.

This credit has been available to taxpayers since 2014. It is not refundable and it has a six-year carryover period. A taxpayer has to meet certain milestones related to employment, compensation level, and investments to be made in the state to earn and use the credit on its California tax return. These milestones are stated in the California Competes Tax Credit Allocation Agreement negotiated between GO-Biz and the taxpayer. Under situations where there is a material breach in the terms of the credit agreement, GO-Biz may recapture the credit from the taxpayer. S Corporations can use only 1/3 the amount earned against their own taxes. However, 100% of the earned credit flows through to their shareholders. This credit can also be assigned to affiliates who are part of the same combined reporting group as the entity that earns the credit. See MATM 9015 for additional information.

Taxpayers should use Form 3531 to report the credit earned, and/or claimed for the current taxable year as well as the amount of carryover to future years. The first year the credit form became available is taxable year 2015.

Subdivision (d) of Sections 17059.2 and 23689 of the Revenue and Taxation Code require the FTB to review the books and records of all taxpayers awarded a CCTC, other than taxpayers that are small businesses. Small businesses are defined as those with gross receipts less than $2 million. It is at FTB's discretion to review the books and records of small business agreements. The purpose of the review is to ensure compliance with the terms and conditions of agreements between the taxpayer and GO-Biz. This review is separate from FTB's regular audit process and is conducted by the Specialized Technical Services Section (STSS) staff within the Technical Resource & Services Bureau.

What should YOU do when you are auditing a taxpayer that has claimed the CCTC on its tax return?

- First, refrain from including the CCTC as an audit issue. You can continue to work your regular audit issues.
- Verify taxpayer eligibility and amount of CCTC available from the CCTC Look-Up Tool before allowing use.
- Document the verified information in the PASS case unit.
- Talk to a CCTC reviewer before closing your case. They are listed on the STSS Webpage.

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