12.0 S CORPORATION AND SHAREHOLDER CREDITS

12.1 GENERAL RULES

Federal Rules
S corporations are not subject to income tax for federal purposes. Thus, for federal purposes, tax credits generated by an S corporation are passed-through to the corporation's shareholders to offset the shareholder's personal federal income tax liability.

In the case of any pass-through entity (partnership or S corporation), the determination of whether a taxpayer is qualified for a particular credit is made at the entity level, and any credit that is allowed to the pass-through entity shall be passed through to the partners or shareholders. Please note that Limited Liability Companies (LLCs) that elect to be taxed as an S corporation or as a partnership are also subject to the pass-through entity rules mentioned in this chapter.

California Rules
In contrast to federal law where S corporations are not subject to federal income tax, all S corporations subject to California tax must pay the minimum franchise tax of $800 or an income or franchise tax at a rate of 1.5 percent. The tax rate for financial S corporations is 3.5 percent. (California Revenue and Taxation Code (R&TC) Sections 23802 and 23186) Therefore, the California S corporation tax may be offset by credits. (R&TC Section 23803)

For California purposes, an S corporation and its shareholders are subject to both Corporation Tax Law (CTL) and Personal Income Tax Law (PITL), respectively. Credits generated at the S corporation level may require application of the PITL for purposes of computing the allowable credit at the shareholder level. (IRC Sections 1363 and 1366; R&TC Sections 23800, 23802, and 23803)

If the credit is allowed only under the CTL, one-third of the credit may be utilized to offset the franchise or income tax at the S corporation level. The remaining two-thirds is disregarded and may not be carried over. No part of the credit may be passed through to the shareholders.

If the credit is only allowed under the PITL, the full credit may be passed through to the S corporation's shareholders, and the S corporation may not use any part of the credit. (R&TC Section 23803(a)(2)(F))

Note: When calculating the Personal Income Tax (PIT) credit amount, apply the PITL (if different from the CTL) to determine the allowable credit. This amount passes through to the shareholders.

If the credit is allowed under both the CTL and PITL, one-third of the credit as determined under CTL may be utilized by the S corporation to offset the tax on net income at the S corporation level. (R&TC Section 23803(a)(1)) The remaining two-thirds must be disregarded and may not be used as a carryover. (R&TC Section 23803(a)(2)(B)) However, the full credit amount as calculated under the PITL may be passed through to the shareholders. (R&TC Section 23803(a)(2)(F))

Note: Separate calculations are required at the corporate level and shareholder levels when a credit is allowed under both the CTL and the PITL. Calculate the credit using the CTL to determine the allowable credit at the S corporation level and calculate the credit using the PITL to determine the allowable credit at the shareholder level.

Example A

For TYE 12/31/2015, XYZ Electronics, a California S corporation, computed its allowable Research Credit of $100,000 in accordance to R&TC Section 23609. However, the S corporation may utilize only one-third of the credit or $33,333 ($100,000 X 1/3) to offset its tax liability. The remaining $66,667 ($100,000 - $33,333) is disregarded.

XYZ Electronics' tax liability for TYE 12/31/2015 was $13,800. It utilized $13,000 of the credit to reduce its tax liability but not below the minimum franchise tax. The remaining amount of the credit of $20,333 ($33,333 – $13,000) is carried over into TYE 12/31/2016.

Credit Carryovers

Credits carried over from C corporation years:

In general, the IRC does not permit credit carryovers between C corporation and S corporation years. (IRC Section 1371(b)(1)) However, for purposes of determining the California S corporation franchise or income tax, R&TC Section 23803 modifies this general rule to allow credit carryovers from C corporation years, subject to the following provisions:

If a C corporation has unused credit carryovers when it elects S corporation status, the carryovers are reduced to 1/3 and transferred to the S corporation. The remaining 2/3 are disregarded. The allowable carryovers may be used to offset the 1.5 percent tax on net income in accordance with the respective carryover rules. However, these C corporation carryovers may not be passed through to S corporation shareholders. (R&TC Section 23803(a)(2)(E))

Example B

XYZ Electronics made a valid California S Corporation election in 2015.

For TYE 12/31/2014 XYZ Electronics, a C corporation, claimed a Research and Development Credit of $80,000 in accordance to R&TC Section 23609. Its tax liability for TYE 12/31/2014 was $15,800. XYZ Electronics utilized $15,000 of the credit to reduce its tax liability but not below the minimum franchise tax. The remaining $65,000 was carried over to the subsequent tax year.

For TYE 12/31/2015 XYZ, Electronics reduced the credit carryover to $21,667 ($65,000 X 1/3) upon conversion from a C corporation to an S corporation. Its tax liability for TYE 12/31/2015 was $10,800, and XYZ utilized $10,000 of the allowable credit carryover to reduce its tax liability but not below the minimum franchise tax.

XYZ Electronics may carry forward the remaining allowable credit of $11,667 to TYE 12/31/2016. However, XYZ cannot pass through the C corporation credit carryovers to its shareholders. Therefore, XYZ shareholders are not entitled to any portion of the $21,667 Research and Development Credit.

Credits carried over to C corporation years:

If a corporation generates a credit during an S corporation year and later converts to a C corporation through termination of its S corporation election, any unused credit cannot be used to reduce C corporation taxes after conversion.

Example C

For TYE 12/31/2015, XYZ Electronics (a Federal and California S corporation) computed its allowable Research Credit of $100,000 in accordance to R&TC Section 23609. The S corporation may utilize only $33,333 ($100,000 X 1/3) to offset its tax liability. The remaining $66,667 ($100,000 - $33,333) is disregarded. XYZ Electronics is not allowed to use any portion of the Research Credit because it reported a taxable loss for TYE 12/31/2015.

Effective January 1, 2016, XYZ Electronics terminated its Federal and California S corporation election by revocation. XYZ Electronics may not carryover the unused $33,333 of the Research Credit to the C corporation years. There are no provisions contained in the Federal or California tax law that allow carryovers between C corporation and S corporation years. If XYZ makes a valid Federal or California S corporation election effective January 1, 2021, (five years from the date of termination), the credit can be used at this time. In other words the credit is not lost upon conversion from an S corporation to C corporation, but rather it is suspended until the taxpayer becomes an S corporation again. (IRC Section 1371(b) and R&TC Section 23806)

Note: The Research Credit of $100,000 generated in 2015 is passed through to the shareholders. The shareholders are entitled to recognize the credit after conversion from an S corporation to a C corporation but are still subject to the credit limitations under IRC Section 41(g).

12.2 AVAILABLE CREDITS

The following are some of the available credits a taxpayer can claim:

12.2.1 Other State Tax Credit
12.2.2 New Employment Credit
12.2.3 California Competes Tax Credit

Each of these credits will be discussed in more detail below.

The California S Corporation Tax Booklet provides a list of the available credits. Each credit has certain requirements that must be satisfied in order to be claimed. Therefore, it is important to read the applicable credit statute and accompanying regulations, if any.

12.2.1 Other State Tax Credit (OSTC)

R&TC Section 18006(b)(1), provides that a shareholder of a California S corporation shall be allowed, for purposes of obtaining the "**Other State Tax Credit**," to treat her/his pro rata share of "net income taxes" paid to another state by the California S corporation as if those taxes had been directly paid by the shareholder. In addition, R&TC Section 18006(b)(2) provides that R&TC Section 18006(b)(1) shall apply **only** if the following requirements are met: (A) that the other state imposing the tax does not allow corporations to elect to be treated as an S corporation, or (B) the other state imposes a tax on S corporations and the California S corporation has elected to be treated as an S corporation in the other state.

R&TC Section 18001(a), provides generally that California residents shall be allowed a credit against the "net tax" for "net income taxes" imposed by and paid to another state on income taxable by California. R&TC Section 18001(a)(1) provides that the **Other State Tax Credit** shall be allowed only for taxes paid to the other state on income derived from sources within that state that is taxable under its laws regardless of the domicile or residence of its recipient. Furthermore, R&TC Section 18001(b) provides that the amount of the "net income taxes" paid to another state shall include the shareholder's pro rata share of any taxes on income paid by an S corporation, as provided by Section 18006. For California nonresidents refer to R&TC Section 18002 for the general requirements that apply. California Schedule S – Other State Tax Credit must be attached to a taxpayer's California Resident or Nonresident tax return. For more information, refer to Legal Ruling 2017-01.

California residents are not allowed an OSTC if the other state allows California residents a credit for net income taxes paid to California. (R&TC Sections 18001(a) and 18001(c))

Example D

In 2015 XYZ Electronics, a California S corporation, apportioned its business income within and without the state and paid a net income tax of $3,000 to State A which does not allow corporations to elect to be treated as an S corporation.
During 2015 XYZ, Electronics had three shareholders who each owned 33.3% of the S corporation's outstanding stock. In accordance to R&TC Section 18006 each shareholder is allowed to claim her/his pro rata share of the taxes paid to State A ($3,000/3=$1,000) as an "Other State Tax Credit." (R&TC Sections 18001 or 18002)

12.2.2 New Employment Credit (NEC)

On July 11, 2013, the NEC was established for businesses located in a designated area in the state of California.

The NEC is available for each taxable year beginning on or after January 1, 2014, and before January 1, 2021. The NEC is only for qualified taxpayers. A qualified taxpayer is an employer engaged in a trade or business within a Designated Geographic Area (DGA), who, during the taxable year, pays qualified wages to a qualified full-time employee, and is not in an excluded business. A qualified taxpayer must hire a qualified full-time employee on or after January 1, 2014, pays or incurs qualified wages attributable to work performed by that employee in a designated census tract, pilot area or former DGA, and receives a Tentative Credit Reservation for that employee. A qualified taxpayer must obtain the Tentative Credit Reservation through an online system that is available on FTB's website. (R&TC Section 23626)

An annual certification of employment is required with respect to each qualified full-time employee hired in a previous taxable year. (R&TC Section 23626) The annual certification of employment is due on or before the 15th day of the third month of the qualified taxpayer's current taxable year. The certification information can be located on FTB's website, search for NEC. The NEC must be claimed on a timely filed original return of the qualified taxpayer. California Form 3554 needs to be prepared and attached to the taxpayer's California tax return.

In order to be allowed a credit, the qualified taxpayer must have a net increase in the total number of full-time employees working in California, when compared to its base year, both determined on an annual full-time equivalent basis. (R&TC Section 23626(b)(2)) Use California Form 3554 Part I – Section A to calculate the total number of annual full-time equivalents working in California during the base year, and Section B to calculate the current year annual full-time equivalents.

Qualified wages are wages paid by the qualified taxpayer during the taxable year to the qualified full-time employee that exceeds 150 percent (or $10 for a Pilot Area) but does not exceed 350percent of minimum wage. The California minimum wage was $9.00 per hour from July 1, 2014, through December 31, 2015, and $10.00 per hour beginning on and after January 1, 2016. Wages for salaried employees must be converted to an hourly amount. A reasonable way to do this would be to divide the annualized salary by 2000 hours. The tentative credit is determined by multiplying the qualified wages for all qualified employees by 35 percent.

Dates	Qualified Wage must exceed	Maximum qualified hourly wage
January 1, 2015 – December 31, 2015	$13.50	$31.50
Pilot Areas January 1, 2015 – December 31, 2015	$10.00	$31.50

Qualified wages are wages paid during the 60 month period beginning with the first day the qualified employee commences employment with the qualified taxpayer in the DGA. For this purpose, commencement of employment or the hire date is the first day for which the individual receives wages/compensation.

If the available credit exceeds the current year tax liability or is limited by tentative minimum tax, the unused credit may be carried over for five years or until the credit is exhausted, whichever occurs first. Apply the carryover to the earliest taxable year. In no event can the credit be carried back and applied against a prior year's tax.

See R&TC Section 23626(b)(10)(A) for the requirements an individual must meet to qualify as a full-time employee

In order to qualify for the NEC, the qualified taxpayer must have a qualified full-time employee performing services for the employer in the DGA. The **DGA** is defined as:

- Designated census tracts that have the highest unemployment and highest poverty in the state.
- Former Enterprise Zones (in existence on December 31, 2011, designated in 2012) and any revision to an EZ prior to June 30, 2013, except census tracts within those EZs with the lowest unemployment and poverty levels.
- Former LAMBRAs (in existence on July 11, 2013).

Pilot Areas
Pilot areas are select areas within the DGA. There may be up to five pilot areas designated at one time. Qualified wages for qualified full-time employees in pilot areas are those wages greater than $10 per hour, up to 350 percent of the state minimum wage at that time.

In 2014, GO-Biz designated the following pilot areas:

1. **Fresno Pilot Area**

The former Fresno City Enterprise Zone, except within census tracts with the lowest unemployment and poverty levels.

2. **Merced Pilot Area**

The former Merced Enterprise Zone, except within census tracts with the lowest unemployment and Poverty levels.

3. **Riverside Pilot Area**

The Riverside Pilot Area includes census tracts 303, 401.01, 402.03, 429.04 and 467 in Riverside County.

These pilot areas are in effect until December 31, 2017. The pilot areas designation may be extended by GO-Biz for an additional period of up to three calendar years. (R&TC Section 23626(b)(12)(II)(aa))

Example E

ABC Company is a qualified taxpayer and has a net increase in full-time employees. ABC Company receives the full amount of the tentative credit. ABC Company is on a calendar year basis and operates entirely within the DGA. For its taxable year 2014, ABC Company has 100 full-time employees based on annual full-time equivalents. During taxable year 2015, ABC Company hired a number of new full-time employees, two of which were qualified full-time employees. ABC Company received a Tentative Credit Reservation for these employees as required.

In accordance with R&TC Section 23626(b)(6)(A) & (B), for a full-time employee paid hourly qualified wages, "annual full-time equivalent" means the total number of hours worked for the qualified taxpayer by the employee (not to exceed 2,000 hours per employee) divided by 2,000. In the case of a salaried full-time employee, "annual full-time equivalent" means the total number of weeks worked for the qualified taxpayer by the employee divided by 52. Again, the net increase in full-time employees is the total number of annual full-time equivalents in the current taxable year, less the annual full-time equivalents in the base year. See California Form 3554 Part I – Section A & B.

Assume the following facts:
James Smith was hired on January 1, 2015, at an hourly wage of $17.00 and on July 1, 2015, his hourly wage was increased to $20.00 per hour. James worked 2,000 hours during taxable year 2015. Jane Jones was hired on July 1, 2015, at an hourly wage of $20.00 and worked 1,000 hours during taxable year 2015.

The qualified wages and tentative credit are computed as follows:

	Actual Wages	**150% of Minimum Wages**	**Qualified Wages**	**Hours Worked**	**Multiply by Applicable Credit Percentage**	**Tentative Credit**
James Smith						
Jan 1 – June 30	$17.00	$13.50	$3.50	1,000	35%	$1,225
James Smith						
July 1 – Dec 31	$20.00	$13.50	$6.50	1,000	35%	$2,275
Jane Jones						
July 1 – Dec 31	$20.00	$13.50	$6.50	1,000	35%	$2,275
Total Tentative Credit						**$5,775**

The Base Year is taxable year 2014. In its base year, annual full-time equivalents were 100. The annual full-time equivalents for 2015 was 108. The net increase in full-time employees over the base year is 8. The credit generated is computed as follows:

Description	Calculation
Numerator	108-100=8 (Net Increase in full-time employees)
Denominator	2 qualified full-time employees
Computation	8/2=100% (the applicable percentage Cannot exceed 100%)
Tentative Credit Amount	$5,775
Credit Generated	$5,775 ($5,775X100%)

12.2.3 California Competes Tax Credit (CCTC)

On July 11, 2013, the CCTC was established for businesses that want to come to California or stay and grow in California. It is an income tax credit. The Governor's Office of Business and Economic Development (GO-Biz) administers the CCTC. The CCTC is available for taxable years beginning on and after January 1, 2014, and before January 1, 2025, to taxpayers that enter into a CCTC Allocation Agreement (credit agreement) with the GO-Biz. Tax credit agreements are negotiated by the GO-Biz and approved by the California Competes Tax Credit Committee. It is a five (5) year agreement. (R&TC Section 23689)

To claim the CCTC, a taxpayer must have entered into a credit agreement with the GO-Biz and met the terms and conditions in the credit agreement. (R&TC Section 23689(a)(2)) The credit is allocated by taxable year as specified in the credit agreement. As part of the credit agreement, a taxpayer commits to meet and maintain yearly employment and project investment requirements, referred to as "milestones." If a taxpayer meets the milestones for a taxable year as specified in the credit agreement, then the credit for that year is earned and may be claimed on the tax return. Please refer to **business.ca.gov** for more information.

GO-Biz will inform FTB of the terms and conditions of the written agreement upon approval of the written agreement by the committee, and of any recapture of a previously allocated credit upon approval of the recapture by the committee. (R&TC Sections 23689(c) (4) & (5))

If the available credit exceeds the current year tax liability, the unused credit may be carried over for up to five years or until the credit is exhausted, whichever occurs first. In no event can the credit be carried back and applied against a prior year's tax. (R&TC Section 23689(e))

Attach FTB Form 3531 to a taxpayer's tax return to report the CCTC amount earned and claimed for the current year, the amount to carryover to future years and any amount recaptured.

FTB is mandated to perform reviews to determine compliance with the credit agreements terms. FTB's Specialized Technical Services Section (STSS) staff are dedicated to work the CCTC program workload. STSS's review is limited to the CCTC – separate from FTB's regular audit workload. STSS staff reviews the taxpayer's books and records to verify annual requirements established in the credit agreements

If an auditor has a case that includes the CCTC, the auditor should contact a STSS staff from the CCTC contact list and refrain from auditing the CCTC. Prior to closing the case, the auditor should speak to a STSS staff to obtain information on the CCTC. The STSS staff will confirm to the auditor if there is an active CCTC agreement and the credit amount available for the year under audit. The auditor should continue with their audit as usual and document the information obtain from STSS in the Pass Case.

12.3 RESEARCH AND DEVELOPMENT CREDIT

12.3.1 General Rules

A California Research & Development (R&D) Credit against corporation franchise (income) and personal income taxes is allowed for amounts paid or incurred for research in accordance with IRC Section 41, and as modified by California. (R&TC Sections 23609 and 17052.12) Taxpayers can elect either the regular incremental credit method or the alternative incremental credit method to report the amount of the R&D Credit. California does not conform to IRC Section 41(c)(5), which allows a taxpayer to elect for federal tax purposes the alternative simplified credit method. (R&TC Section 23609(h)(4))

S corporations, partnerships, and LLCs should complete FTB Form 3523, *Research Credit*, to compute the amount of research credit generated. Attach the form to the entity's California tax return. Show the distribute share of the pass through credit for each shareholder, partner, or member on Schedule K-1. The shareholder, partner, or member also need to attach FTB Form 3523 to their California tax return.

S corporations may claim only one-third of the research credit against the 1.5 percent franchise or income tax (3.5 percent for financial S corporations) after applying the limitations relating to passive activity losses and credits. (R&TC Section 24692) S corporations must use FTB Form 3801 to compute the allowable net loss from passive activities and FTB Form 3801-CR to compute their passive activity credit limitation. S corporations can pass through 100 percent of the research credit to their shareholders on a pro-rata basis.

In the case where the credit allowed by R&TC Section 23609 exceeds the "tax," the excess may be carried over to reduce the "tax" in the following year, and succeeding years if necessary, until the credit has been exhausted. Apply the carryover to the earliest taxable year. In no event can this credit be carried back and applied against a prior year's tax. (R&TC Section 23609(f))

The regular incremental credit amount is 15 percent of the excess California qualified research expenses for the taxable year over the base period amount. California also allows a credit for 24 percent of basic research payments. (R&TC Section 23609(b)(3)) However, an S corporation is not eligible to report the basic research credit in accordance with IRC Section 41(e)(7)(E).

For the regular incremental credit, if a taxpayer has no California gross receipts (under Legal Division Guidance 2012-03-01), a taxpayer must calculate the fixed-base percentage as a start-up company, using as "year one" the first taxable year beginning on or after January 1, 1994, in which the taxpayer has qualified research expenses. In the taxpayer's sixth year and beyond, if a mathematical calculation is impossible because division by zero gross receipts results in a mathematical error, the statutory language of IRC Section 41(c)(3)(C) controls, and the taxpayer must use a fixed-base percentage of 16 percent (.16).
The terms "qualified research" and "basic research" include only research conducted in California. (R&TC Section 23609(c)(2)) California modifies IRC Section 41(b)(1) to exclude from "qualified research expense" amounts paid for property qualifying for sales and use tax exemption under California R&TC Section 6378). (R&TC Section 23609(c)(1))

For the alternative incremental research credit (AIRC) amount California conforms with modifications to the former federal alternative incremental credit in IRC Section 41(c)(4), which allows taxpayers to elect an alternative incremental research credit method for computing the research credit. (R&TC Section 23609(h)(1)) The California alternative incremental credit is computed as a percentage of a taxpayer's qualified research expenses in excess of its average gross receipts for the previous four years. Under this alternative credit method, a credit rate of:

- 1.49 percent applies to the extent that a taxpayer's current-year California qualified research expenses exceed a base amount computed by using a fixed-base percentage of 1 percent but do not exceed a base amount computed by using a fixed base percentage of 1.5 percent. (R&TC Section 23609(h)(1)(A)

- 1.98 percent applies to the extent that a taxpayer's current-year California qualified research expenses exceed a base amount computed by using a fixed-base percentage of 1.5 percent but do not exceed a base amount computed by using a fixed base percentage of 2 percent. (R&TC Section 23609(h)(1)(B)

- 2.48 percent applies to the extent that a taxpayer's current-year California qualified research expenses exceed a base amount computed by using a fixed-base percentage of 2 percent. (R&TC Section 23609(h)(1)(C)

If a taxpayer has no California gross receipts (under Legal Division Guidance 2012-03-01), the taxpayer cannot use the alternative incremental credit; the taxpayer must use the regular credit as a start-up company.

An election to be subject to this alternative incremental credit method may be made only for a taxpayer's first taxable year beginning on or after January 1, 1998. The election applies for all succeeding years unless revoked with the FTB's consent. (R&TC Section 23609(h)(2))

The California AIRC is a separate election and must follow the rules under R&TC Section 23609(h) including getting permission to revoke the election. For federal purposes, taxpayers may automatically revoke a federal election by filing the regular method on its original return. However, California has not updated its law to allow a similar automatic revocation and taxpayers must still request consent from FTB to revoke the California election. TRSB keeps records of taxpayers' requests to revoke the AIRC election.

Also refer to FTB 1082, *Research and Development Credit: Frequently Asked Questions*.

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12.3.2 Federal / State Differences

As a result of the numerous federal and state differences, as well as several law changes since the enactment of R&TC Section 23609 and IRC Section 41, you should refer to the statute and accompanying regulations for each tax year.

California R&TC Section 23609 has made the following current modification from federal to state law regarding the R&D Credit:

- For purposes of the California research credit, "qualified research" only includes research conducted in California. (R&TC Section 23609(c)(2)(A))

- For each taxable year beginning before January 1, 1997:
  - The reference to 20 percent in IRC Section 41(a)(1) is modified to 8 percent
  - The reference to 20 percent in IRC Section 41(a)(2) is modified to 12 percent

- For each taxable year beginning on or after January 1, 1997 and before January 1, 1999:
  - The reference to 20 percent in IRC Section 41(a)(1) is modified to 11 percent
  - The reference to 20 percent in IRC Section 41(a)(2) is modified to 24 percent

- For each taxable year beginning on or after January 1, 1999 and before January 1, 2000:
  - The reference to 20 percent in IRC Section 41(a)(1) is modified to 12 percent

   - The reference to 20 percent in IRC Section 41(a)(2) is modified to 24 percent

- For each taxable year beginning on or after January 1, 2000:
   - The reference to 20 percent in IRC Section 41(a)(1) is modified to 15 percent
   - The reference to 20 percent in IRC Section 41(a)(2) is modified to 24 percent

- The provisions of IRC Section 41(e)(7)(A) are modified so that "basic research," for the purpose of this section, includes any basic or applied research including scientific inquiry or original investigation for the advancement of scientific or engineering knowledge or the improved effectiveness of commercial products, except that the term does not include any of the following:

   - Basic research conducted outside of California.
   - Basic research in the social sciences, arts, or humanities.
   - Basic research for the purpose of improving a commercial product if the improvements relate to style, taste, cosmetic, or seasonal design factor.
   - Any expenditure paid or incurred for the purpose of ascertaining the existence, location, extent or quality of any deposit of ore or other mineral (including oil & gas).

An S corporation is not eligible to report the basic research credit in accordance with IRC Section 41(e)(7)(E).

12.3.3 Qualified Research

R&TC Section 23609 substantially conforms to IRC Section 41. To determine the amount of a taxpayer's Qualified Research Expenses (QREs), the taxpayer must determine whether any of its activities constitute "qualified research" as defined in IRC Section 41(d), and then determine which costs attributable to the qualified research constitute QREs under IRC Section 41(b). QREs include in-house research expenses and contract research expenses in accordance with IRC Section 41(b)(1).

To be qualified research, the claimed research must meet the following four (4) requirements or tests set forth in IRC Section 41(d)(1):

(1) The research expenditures must qualify as expenses under IRC Section 174 (the section 174 test);

(2) The research activity must be undertaken for the purpose of discovering information that is technological in nature (the technological information test);

(3) The research activity must be undertaken for the purpose of discovering information the application of which is intended to be useful in the development of a new or improved business component of the taxpayer (the business component test); and

(4) Substantially all of the research activities must constitute elements of a process of experimentation for a qualified purpose (the process of experimentation test).

IRC Section 41(d)(4) specifically excludes a number of activities from the definition of qualified research, such as (i) routine and ordinary testing, (ii) adaptation of an existing business component, (iii) duplication of an existing business component, (iv) activity occurring after the beginning of commercial production, (v) funded research, which is any research for which the taxpayer received actual payment, including any research funded by any grant, contract, or otherwise by another person or government entity.

A qualified research activity must meet all four tests to be considered for the California R&D Credit. Apply the tests separately to each business component of the taxpayer. (IRC Section 41(d)(2)(B). A "business component" includes, in pertinent part, a product or process that the taxpayer either holds for sale, lease, or license or uses in its trade or business. (IRC Section 41(d)(2)(B) In the case of a production process, IRC Section 41(d)(2)(C) provides that "Any plat process, machinery, or technique for commercial production of a business component shall be treated as a separate business component (and not as part of the business component being produced)."

If a business component as a whole fails the qualified research tests, a taxpayer may apply the "shrinking-back rule," which allows the taxpayer to apply the qualified research tests to a subset of the business component if doing so will allow the subset to satisfy those tests. (Treasury Regulation Section 1.41-4(b)(2)) The shrinking-back rule provides that if the qualified research tests are not satisfied at the level of the discrete business component, they are then applied to the most significant subset of elements of the business component. The shrinking-back continues until either a subset of the business component satisfies the tests or the most basic element of the business component is reached and fails to satisfy the tests.

If a taxpayer simply provides a list of every project but does not identify the discrete business components for which the taxpayer claims the R&D credit the FTB may deny the research credit in full when the taxpayer fails to identify the business components generating the alleged qualified research expenses. (Bayer v. United States, (2012) 850 F.Supp,2d 522)

12.3.4 Qualified Research Expenses

To be eligible for the research credit under IRC Section 41(a)(1), a taxpayer must incur QREs during the credit year. QREs are generally defined as the sum of the taxpayer's in-house research expenses and contract research expenses that are paid or incurred during the taxable year in carrying on the taxpayer's business. (IRC Section 41(b) The phrase "in carrying on a trade or business" has the same meaning for purposes of IRC Section 41(b)(1) as it has for purposes of IRC Section 162; thus, expenses paid or incurred in connection with a trade or business within the meaning of IRC Section 174(a) (relating to the deduction for research and experimental expenses) are not necessarily paid or incurred in carrying on a trade or business for purposes of IRC Section 41. A research expense must relate to a particular trade or business being carried on by the taxpayer at the time the expense is paid or incurred in order to be a qualified research expense. (Treasury Regulation Section 1.41-2(a))

In relevant part, IRC Section 41(b)(2)(A) defines in-house research expenses as:

(i) Any wages paid or incurred to any employee for qualified services performed by such employee, and
(ii) Any amount paid or incurred for supplies used in the conduct of qualified research.

IRC Section 41(b)(2)(C) defines the term "supplies" as any tangible property other than:

(i) Land or improvements to land, and
(ii) Property of a character subject to the allowance for depreciation.

Supplies must be used in the conduct of qualified research for their costs to constitute QREs. (IRC Section 41(b)(2)(A)(ii) Amounts incurred for supplies or property used only indirectly for qualified research or for general and administrative expenses are not QREs. (Treasury Regulation Section 1.41-2(b)(1))

With respect to wages, qualified services are defined as services consisting of "engaging in qualifying research" or "engaging in the direct supervision or direct support of research activities which constitute qualified research." (IRC Section 41(b)(2)(B) The term "engaging in qualified research" means the actual conduct of qualified research (as in the case of a scientist conducting laboratory experiments). The term "direct supervision" means the immediate supervision (first-line management) of qualified research (as in the case of a research scientist who directly supervises laboratory experiments, but who may not actually perform experiments). "Direct supervision" does not include supervision by a higher-level manager to whom first-line managers report, even if that manager is a qualified research scientist. "Direct support" means services in the direct support of either (i) persons engaging in actual conduct of qualified research or (ii) persons who are directly supervising persons engaging in the actual conduct of qualified research. (Treasury Regulation Section 1.41-2(c))

Wages paid to or incurred for an employee constitute in-house research expenses only to the extent the wages were paid or incurred for qualified services performed by the employee. If an employee has performed both qualified services and nonqualified services, only the amount of wages allocated to the performance of qualified services constitutes an in-house research expense. If substantially all of the services performed by an employee during the taxable year consist of engaging in qualified research or engaging in the direct supervision or direct support of research activities which constitute qualified research, the term "qualified services" means all of the services performed by the employee during the taxable year. (IRC Section 41(b)(2)(B))

The "substantially all" threshold is satisfied with respect to an employee if the wages appropriately apportioned to qualified research services constitute at least 80 percent of the wages paid to or incurred by the taxpayer for the employee during the taxable year. (Treasury Regulation 1.41-2(d)) In the absence of an alternative method that the taxpayer demonstrates is more appropriate, the amount of wages properly allocable to qualified services is determined by "multiplying the total amount of wages paid to or incurred for the employee during the taxable year by the ratio of the total time actually spent by the employee in the performance of qualified services for the taxpayer to the total time spent by the employee in the performance of all services for the taxpayer during the taxable year." (Treasury Regulation Section 1.41-2(d)(1))

A contract research expense is 65 percent of any expense paid or incurred in carrying on a trade or business to any person other than an employee of the taxpayer for the performance on behalf of the taxpayer of (i) qualified research as defined in Treasury Regulation Sections 1.41-4 or 1.41-4A, whichever is applicable, or (ii) services which, if performed by employees of the taxpayer, would constitute qualified services within the meaning of IRC Section 41(b)(2)(B)). (Treasury Regulation Section 1.41-2(e))

A contract research expense is paid or incurred for the performance of qualified research only to the extent that it is paid or incurred pursuant to an agreement that (i) is entered into prior to the performance of the qualified research, (ii) provides that research be performed on behalf of the taxpayer, and (iii) requires the taxpayer to bear the expense even if the research is not successful. (Treasury Regulation Section 1.41-2(e))

If a contract research expense is paid or incurred pursuant to an agreement under which payment is contingent on the success of the research, then the expense is considered paid for the product or result rather than the performance of the research, and the payment is not a contract research expense. Qualified research is performed on behalf of the taxpayer if the taxpayer has a right to the research results. Qualified research can be performed on behalf of the taxpayer notwithstanding the fact that the taxpayer does not have exclusive rights to the results.

The performance of all the contract research must be performed in California.

12.3.5 Base Amount

The research expense credit is allowed to the extent that a taxpayer's California qualified research expenses for the credit year exceed its California base amount for that year. (IRC Section 41(c))

The base amount is the amount derived from multiplying:

- The fixed-base percentage by
- The average annual gross receipts of the taxpayer for the four tax years before the credit year.

But in no event may this base amount be less than 50 percent of the QREs for the credit year.

The fixed-base percentage, for a taxpayer that isn't a startup company, is the percentage which the total California qualified research expenses of the taxpayer for tax year beginning after December 31, 1983, and before January 1, 1989, is of the total California gross receipts of the taxpayer for those tax years.

The fixed-base percentage base-period is a five-year period, and the gross receipts base period for the determining "average annual gross receipts" is the four-year period before the credit year.

When computing gross receipts under IRC Section 41(c)(7), a taxpayer needs to reduce from gross receipts, for any taxable year, any returns and allowances made during the taxable year. In the case of an S corporation that operates within and outside California, R&TC Section 23609(h)(3) modifies the federal computation to take into account only those gross receipts from the sale of property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business that is delivered or shipped to a buyer in California, regardless of F.O.B. point or other conditions of sale. This includes sales to the U.S. government that are delivered or shipped to customers in California. Throwback sales and receipts from services, rents, operating leases and interest, royalties and licenses are excluded from the computation.

Example F

For TYE 12/31/2015, XYZ Electronics has total California qualified research expenses of $210,000. In determining the fixed-base percentage, XYZ Electronics' records show the following California qualified research expenses and California qualified gross receipts:

Year	CA Qualified Research Expenses	CA Qualified Gross Receipts
1988	$100,000	$1,300,000
1987	90,000	1,000,000
1986	80,000	800,000
1985	70,000	600,000
1984	50,000	500,000
TOTAL	$390,000	$4,200,000

For TYE 12/31/2015, XYZ Electronics' fixed-base percentage is 9.29% computed by dividing the total CA qualified research expenses of $390,000 for the 1984 to 1988 period by the total CA gross receipts of $4,200,000 for the same period.

Assuming XYZ Electronics' average gross receipts for TYE 12/31/2015 is $1,150,000, then the base amount for TYE 12/31/2015 for XYZ Electronics is $106,835 (9.29% multiply by $1,150,000).

The fixed-base percentage for a start-up company is computed differently. A start-up company is one that had both gross receipts and qualified research expenses during either of the following periods:

1. For the first time in a taxable year beginning after December 31, 1983.

2. For fewer than three taxable years beginning after December 31, 1983 and before January 1, 1989.

A start-up company has a 10-year phase in period leading up to a credit based on five years of experience. The fixed-base percentage is 3 percent for each of an S corporation's first five taxable years beginning on or after January 1, 1994, that the taxpayer has qualified research expenses. To determine the fixed-bases percentages for the sixth through tenth years, see IRC Section 41(c)(3)(B)(ii).

For existing corporations and a start-up company, the maximum fixed-base percentage a taxpayer can report is 16 percent (.16). Also, the base amount cannot be less than 50 percent of the current qualified research expenses for both the existing and start-up companies.

If a taxpayer has no California gross receipts (under Legal Division Guidance 2012-03-01), the taxpayer cannot use the alternative incremental credit; the taxpayer must use the regular credit as a start-up company.

A taxpayer must calculate the fixed-base percentage as a start-up company, using as "year one" the first taxable year beginning on or after January 1, 1994, in which the taxpayer has qualified research expenses. In the taxpayer's sixth year and beyond, if a mathematical calculation is impossible because division by zero gross receipts results in a mathematical error, the statutory language of IRC Section 41(c)(3)(C) controls, and the taxpayer must use a fixed-base percentage of 16 percent (.16).

12.3.6 Credit Computation

Under the current regular incremental research credit a taxpayer is allowed to apply a 15 percent rate to the excess of California qualified research expenses for the taxable year over the California base amount. (R&TC §23609(b)(2)) California qualified research expenses of start-up companies also qualify for the research credit but under a different base amount formula.

Example G

In Example F above, XYZ Electronics' fixed-base percentage for TYE 12/31/2015 is 9.29%. Its average gross receipts for TYE 12/31/2015 is $1,150,000. The average gross receipts amount reflects the four tax years before the credit year, 12/31/2011, 12/31/2012, 12/31/2013 and 12/31/2014.

The base amount for TYE 12/31/2015 is $106,835 (9.29% multiply by $1,150,000).

The 15% credit rate is applied to the excess of current year California qualified research expenses over the "base amount." Thus, the 15% credit rate is applied to $103,165 (that is, $210,000 of current year California qualified research expense less the base amount of $106,835). The base amount may not be less than 50% of the QRE's for the credit year. In this example, the base amount is not less than $105,000 or 50% of the QREs ($210,000 multiply by 50%).

Therefore, the California research expense credit for XYZ Electronics for TYE 12/31/2015 is $15,475 (that is, 15% of $103,165).

12.3.7 Reduced Credit

Unless an S corporation makes an election to reduce the research credit under IRC Section 280C(c), any deduction of research and experimental expenditures under IRC Section 174 or any other deduction or credit provision for research expenses or basic research payments must be reduced by the full amount of the research credits allowable under IRC Section 41.

The add-back of the research credit must be shown as a state adjustment. The taxpayer is required to attach a schedule to its tax return that lists the deduction amounts (or capitalized expenses) that were reduced by the IRC Section 41 credits. (R&TC Section 24440)

If an S corporation elects to reduce the research credit under IRC Section 280C(c), a reduction of its IRC Section 174 expenditures will not be necessary. For TYE 12/31/2015, the applicable percentage for an S corporation to reduce its research credit is 98.5 percent (.985). The applicable percentage for an individual (shareholder) to reduce its research credit is 87.7 percent (.877).

Example H

For TYE 12/31/2015, XYZ Electronics, an S corporation, generated a $15,475 research credit. It elects to reduce the research credit in accordance to IRC Section 280C(c). The S corporation computes the research credit as follows:

Step 1: $15,475 X 1/3 = $5,158 (regular credit)
Step 2: $5,158 X 98.5% (.985) = $5,081 (reduced regular credit)

Sandra Martinez is the sole shareholder (100%) in XYZ Electronics. Sandra materially participates in the business of the S corporation, holds no interest in any passive activity, and does not have any nonpassive activity credit carryovers from previous years. The election by XYZ Electronics to reduce the research credit also applies to Sandra. Her taxable year 2015 pass-through research credit is computed as follows:

Step 1: $15,475 X 100% (1.0) = $15,475 (regular credit)
Step 2: $15,475 X 87.7% (.877) = $13,572 (reduced regular credit)

The amount of the reduced regular credit of $13,572 is the pass-through research credit available to Sandra for her 2015 taxable year.

If an S corporation elects to reduce the research credit, the amount of research credit passed through to the shareholder on Schedule K-1 should reflect a research credit amount in which the applicable credit reduction percentage has been applied. See example H above related to an individual shareholder. The shareholder must make an election of the credit reduction consistent with that of the pass-through entity. However, the credit reduction percentage may differ from that of the pass-through entity.

12.3.8 IRC Section 41(g)

California conforms to the IRC Section 41(g) special rule for the pass-through of the research credit, which provides that in the case of an individual owning an interest in an unincorporated trade or business, a partner in a partnership, a beneficiary of a estate or trust, or an S corporation shareholder, the amount of the credit for any taxable year cannot exceed an amount (separately computed with respect to such person's interest in the trade, or business, or entity) equal to the tax attributable to that person's taxable income which is allocable or apportionable to the person's interest in the trade, business, or entity. This means, for example, that if in a particular year an individual had no taxable income from an S corporation, the individual wouldn't be able to claim any credit that year for the research expenses of the S corporation. **Note:** With respect to the computation of the 41(g) limitation, **taxable income** for a shareholder includes the salaries or wages received from the qualifying S corporation activity. (Treasury Regulation 1.53-3)

California does not conform to the last sentence of IRC Section 41(g), relating to the carryover of excess credits. Instead, California provides that if the amount of the credit exceeds the limitation of IRC Section 41(g), the excess may be carried over in to the following year (and succeeding years, if necessary) until exhausted except that the limitation of IRC Section 41(g) will be taken into account in each subsequent taxable year. (R&TC Section 23609(j))

The above limitation rule for the pass-through of the research credit is applied in accordance with similar rules under Federal Regulation Section 1.53-3.

Formula to Determine Credit Limitation

Credit Limit= $\dfrac{\text{Taxable income attributable to your interest in the pass-through entity (Schedule K-1)}}{\text{Total taxable income for the year (Form 540, line 19 or Long Form 540NR, line 19)}}$ X (Net income tax)

For purposes of completing the above formula, **net income tax** is regular tax (from Form 540, line 35 or Long Form 540NR, line 42) **plus** alternative minimum tax (from Form 540, line 61; or Long Form 540NR, line 71)

The percentage representing taxable income attributable to an individual's interest in the business to the individual's total taxable income for the year cannot exceed 100 percent. If in the current taxable year an individual had no income attributable to a particular business interest, the individual cannot claim any research credit related to that business for the year. See above for carryover of excess credits.

If an individual has pass-through research credits from more than one business interest, the individual is required to compute the research credit limitation separately for each business interest by applying the above formula to each pass-through credit.

12.3.9 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 section 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 Section 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 Section 1.41-6(d)).

Treasury Regulation Section 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 section 1.52-1(b)-(g), will be considered members of the same controlled group for R&D Credit purposes. Treasury Regulation section 1.52-1(b) defines "Organizations" as corporations, partnerships, estates and 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 section 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 (that is, 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 section 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.

12.3.10 Federal Determinations

As a general rule, the practice of the FTB is to follow an on-point final federal determination in research credit cases. In situations in which the IRS issued a "no change," FTB will generally follow the federal determination if the federal examination of the research credit issue is on-point. However, it is not always clear how to apply the federal determination, especially if there was no review of the research credit at the federal level.

There are certain situations where FTB would not automatically follow federal actions for research credit cases or would need to inquire further into the credit computation. For example, California requires that qualified research activities be conducted within California, thus an inquiry may be needed in order to verify that the qualified research was performed within California. (For more examples see California FTB Tax News No. 05/01/2015.)

If FTB needs to inquire further to verify because following the federal determination is not appropriate, it will minimize duplication of audit requests on taxpayers. In some instances it may be mutually beneficial to use a closing agreement in federal action research credit cases. The use of closing agreements can provide a quicker resolution with assured terms for taxpayers.

The following are some FTB Tax News articles regarding the California Research Credit.

- February 2018 - Recent IRS Directive for the California Research Credit
- May 2015 - Following a Federal Determination for Research Credit Cases
- November 2014 - Following Federal in a Research Credit Case

12.3.11 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/law/Closing-Agreement-Program.shtml.

12.4 REPEALED/EXPIRED CREDITS

Economic Development Area (EDA) Tax Incentives

California established four types of EDAs that have related tax incentives, (for example, hiring credits, sales or use tax credits, business expense deduction and Net Operating Loss (NOL) carryover). The following are the EDAs:

- Enterprise Zones (EZ)

  The California legislature repealed the EZ on January 1, 2014. EZs were established in California to provide tax incentives to businesses and allow private sector market forces to revive the local economy. The program offers tax incentives such as a hiring credit, sales or use tax credit, business expense deduction, net interest deduction and net operating loss (NOL) deduction to entities located in selected EZ areas and engaged in a trade or business within the selected Standard Industrial Codes (SIC). (R&TC Sections 23622.7, 23612.2, 24356.7, 24384.5 and 24416.2) The SIC can be located in the California Enterprise Zone Business Booklet.

Similarly, an entity can no longer generate any EZ sales or use tax credit for taxable years beginning on or after January 1, 2014. However, the entity can claim the EZ sales or use tax credit carryover from previous years to the extent of the amount of tax on the business income apportioned to the former EZ. The portion of any credit remaining for carryover to taxable years beginning on or after January 1, 2014, shall be carried over only to the succeeding 10 taxable years if necessary, or until the credit is exhausted, whichever occurs first.

In addition, an entity can no longer generate any EZ net interest deduction, EZ business expense deduction and EZ NOL deduction for taxable years beginning on or after January 1, 2014. However, an S corporation can claim an EZ NOL carryover deduction from prior years to the succeeding 10 taxable years if necessary.

- Local Agency Military Base Recovery Areas (LAMBRA)

The California legislature repealed the LAMBRA on January 1, 2014. LAMBRAs were established to stimulate growth and development in areas that experienced military base closures. The program offers tax incentives such as a hiring credit, sales or use tax credit, business expense deduction, and net operating loss (NOL) deduction to entities operating or investing in a business located within a designated LAMBRA and engaged in a trade or business listed in a Principal Business Activity (PBA) Code. (R&TC Sections 23646, 23645, 24356.8 and 24416.5) The PBA Code can be located on the California "Local Agency Military Base Recovery Area Business Booklet." The booklet also contains FTB Form 3807, *Local Agency Military Base Recovery Area Deduction and Credit Summary,* that a taxpayer is required to attach to their California tax return.

To claim any LAMBRA credit or deduction an S corporation must attach a complete FTB Form 3807 to its California tax return. Attach a separate FTB Form 3807 for each business operating or investing within a designated LAMBRA. Pass-through entities can no longer generate any LAMBRA hiring credit for taxable years beginning on or after January 1, 2014. For employers engaged in a trade or business of a repealed LAMBRA, the hiring credit can be taken for qualified employees hired on or before December 31, 2013, for the full 60-month period of the hiring credit. Hiring credits and carryovers may still be claimed to the extent of business income apportioned to the repealed LAMBRA. The portion of any credit remaining for carryover to taxable years beginning on or after January 1, 2014, shall be carried over only to the succeeding 10 taxable years if necessary, or until the credit is exhausted, whichever occurs first. Any hiring credits generated in the current taxable year for employees hired on or before December 31, 2013, and unusable in the current taxable year, may be carried over to the succeeding 10 taxable years.

Similarly, an entity can no longer generate any LAMBRA sales or use tax credit for taxable years beginning on or after January 1, 2014. However, the entity can claim the LAMBRA sales or use tax credit carryover from previous years to the extent of the amount of tax on the business income apportioned to the former LAMBRA. The portion of any credit remaining for carryover to taxable years beginning on or after January 1, 2014, shall be carried over only to the succeeding 10 taxable years if necessary, or until the credit is exhausted, whichever occurs first.

In addition, an entity can no longer generate any LAMBRA business expense deduction and LAMBRA NOL deduction for taxable years beginning on or after January 1, 2014. However, an S corporation can claim a LAMBRA NOL carryover deduction from prior years.

- Manufacturing Enhancement Area (MEA)

The MEA has expired as of December 31, 2012. S corporations investing or operating within an MEA may be eligible for a hiring credit if both the entity and the hired employees meet the requirements of R&TC Section 23622.8. California's two MEAs are the cities of Brawley and Calexico, located in Imperial County. The program offers the hiring credit tax incentive to encourage business and stimulate job creation in the area. An S corporation must be engaged in a trade or business within the selected SIC and PBA Codes to qualify for the MEA hiring credit. SIC and PBA Codes can be located in the California "Manufacturing Enhancement Area Business booklet." The booklet also contains FTB Form 3808, *Manufacturing Enhancement Area Credit Summary*, that a taxpayer is required to attach to their California tax return.

To claim the MEA hiring credit an S corporation must attach a completed FTB Form 3808 to its California tax return. Pass-through entities can no longer generate MEA hiring credits for employees hired on or after January 1, 2013. However, a qualified entity can generate MEA hiring credits for qualified employees hired prior to the MEA expiration date for wages paid or incurred within the 60-month period of the MEA hiring credit.

The portion of any MEA hiring credit remaining for carryover to taxable years beginning on or after January 1, 2014, shall be carried over only to the succeeding 10 taxable years if necessary, or until the credit is exhausted, whichever occurs first. Any hiring credits generated in the current taxable year for employees hired on or before December 31, 2012, and unusable in the current taxable year, may be carried over to the succeeding 10 taxable years.

- Targeted Tax Area (TTA)

The TTA has expired as of December 31, 2012. California established the TTA program to stimulate development in a selected economically depressed area of Tulare County. The program offers special tax incentives such as a Hiring Credit, Sales, or Use Tax Credit and NOL Carryover Deduction to S corporations located in the Tulare TTA and engaged in a trade or business within the selected SIC. (R&TC Sections 23634, 23633 and 24416.6) The SIC can be located in the California "Targeted Tax Area Business Booklet." The booklet also contains FTB Form 3809, *Targeted Tax Area Deduction and Credit Summary*, that a taxpayer is required to attach to their California tax return.

To claim any TTA credit or deduction an S corporation must attach a complete FTB Form 3809 to its California tax return. Pass-through entities can no longer generate the TTA hiring credit for employees hired on or after January 1, 2013. However, a qualified entity can generate TTA hiring credits for qualified employees hired prior to the TTA expiration date for wages paid or incurred within the 60-month period of the TTA hiring credit. Similarly, an entity can no longer claim a sales or use tax credit for assets purchased and/or placed in service on or after January 1, 2013. In addition, an entity can no longer generate any TTA NOL for taxable years beginning on or after January 1, 2013, but it can claim an NOL carryover deduction from prior years.

The portion of any TTA hiring credit or sales or use tax credit remaining for carryover to taxable years beginning on or after January 1, 2014, shall be carried over only to the succeeding 10 taxable years if necessary, or until the credit is exhausted, whichever occurs first. Any hiring credits generated in the current taxable year for employees hired on or before December 31, 2012, and unusable in the current taxable year, may be carried over to the succeeding 10 taxable years.

- Manufacturers' Investment Credit (MIC)

The MIC expired on January 1, 2004. It is a credit available to a qualified taxpayer that may be used to reduce the taxpayer's income or franchise tax. The credit is 6 percent of qualified costs paid or incurred on or after January 1, 1994, and before January 1, 2004, for acquiring, constructing, or reconstructing qualified property. It is available to qualified taxpayers engaged in manufacturing-type activities. The credit is claimed on the return filed for the taxable or income year in which the qualified property is placed in service in California. (R&TC Sections 23649-0 through 23649-11)

Although costs to construct or acquire property may have been paid or incurred during 2003 or prior years, if the property is not placed in service before January 1, 2004, none of those costs are qualified costs for the credit.

A credit carryover is allowed for a credit generated on or after January 1, 1994, and before January 1, 2004. The credit may generally be carried over for a maximum of eight years. However, if the qualified taxpayer met the definition of a small business as of the last day of the taxable year in the year the credit was allowed, then the credit may be carried over for ten years.

After 2005, the FTB Form 3535 (Manufacturers' Investment Credit) is no longer available. A taxpayer is required to report its MIC carryovers on California Form 3540, *Credit Carryover and Recapture Summary*.

According to the carryover provisions, the MIC carryover has expired during the 2012 taxable year. For a small business, the MIC carryover has expired during the 2014 taxable year.

FTB Form 3540, *Credit Carryover and Recapture Summary*, lists all the credits that have been repealed but which have a carryover or recapture provisions. The taxpayer may claim these credits only if carryovers are available from prior years.

12.5 TAXES NOT REDUCED BY CREDITS AND CREDIT CARRYOVERS

In general, credits and credit carryovers are allowed to offset tax at the S corporation level. (R&TC Section 23803) However, credits and credit carryovers may not reduce the following S corporation taxes:

Minimum Franchise Tax -- R&TC Section 23802(c) imposes a minimum franchise tax as provided in R&TC Section 23153. The tax imposed for any taxable year shall not be less than the minimum franchise tax. (R&TC Section 23151.1(e))

QSub Annual Tax -- A Q Sub is subject to an $800 annual tax which is paid by the S corporation parent. (R&TC Section 23800.5(a)(1)(B))

Built-In-Gains Tax -- IRC Section 1374 imposes a tax on built-in gains and allows certain credits to reduce such tax. R&TC Section 23809(b) modifies IRC Section 1374 by disallowing credits against the California built-in gains tax.

Excess Net Passive Income (ENPI) Tax -- IRC Section 1375 imposes a tax on excess net passive income and allows certain credits to reduce such tax. R&TC Section 23811(c) modifies IRC Section 1375 by disallowing credits against the California ENPI tax.

Increase in tax imposed for the deferral of installment sale income -- R&TC Section 23802(b) subject S corporations that qualify under Part 11, Chapter 4.5 of the Revenue and Taxation Code (Tax Treatment of Scorporations & Their Shareholders) to taxes imposed under Chapter 2 (Corporation Franchise Tax - commencing with R&TC Section 23101) and Chapter 3 (Corporation Income Tax - commencing with R&TC Section 23501). Therefore, the increase in tax required by either R&TC Section 24667(e)(1) or (f)(2) is not considered a “tax” and cannot be reduced by the credits.

Under Chapter 1 (General Provisions & Definitions for the Corporation Tax Law) R&TC Section 23036(a)(2) defines the term “tax” not to include any amount imposed under paragraph (1) of subdivision (e) of R&TC Section 24667, Reporting of Income from Installments Sales, or paragraph (2) of subdivision (f) of R&TC Section 24667.

Installment of LIFO recapture tax -- IRC Section 1363(d)(1) requires a C corporation that inventoried goods under the LIFO inventory method during its last taxable year before electing to be treated as an S corporation, to include into the income of the last C corporation tax year the LIFO recapture amount. A result of additional tax is payable in four equal installments over four tax years. The first installment is payable with the final return as a C corporation (IRC Section 363(d)(2)) and the remaining three payments are made with the S corporation Return. R&TC Section 23802(g)(2) modifies IRC Section 1363 by disallowing credits against the California installment LIFO recapture tax.

12.6 CREDIT RECAPTURES

Tax credits often have provisions requiring that an amount of the credit taken by a taxpayer in an earlier year be added back to the taxpayer's tax (or "recaptured") in a subsequent year if the taxpayer does not meet specified standards of performance. These recapture provisions are often tied to the creation or retention of a specific number of jobs. Another common recapture provision is to require use of the property for a specified period or in a specified geographic location. An S corporation must complete Schedule J, line 5, of the S Corporation Tax Return, if the S corporation reports a credit recapture amount on any of the FTB credit forms.

The following are identified credits containing recapture provisions:

- California Competes Tax Credit (CCTC):
  FTB Form 3531: R&TC Section 23689
- New Employment Credit (NEC):
  FTB Form 3554: R&TC Section 23626
- Enterprise Zone (EZ) Hiring Credit: FTB Form 3805Z: R&TC Section 17053.74 and R&TC Section 23622.7
- Local Agency Military Base Recovery Area (LAMBRA):
  FTB Form 3807: R&TC Section 17053.46 and R&TC Section 23646
- Manufacturing Enhancement Area Hiring Credit (MEA):
  FTB Form 3808: R&TC Section 17053.47 and R&TC Section 23622.8
- Targeted Tax Area Hiring Credit (TTA): FTB Form 3809: R&TC Section 17053.34 and R&TC Section 23634

12.7 REDUCING EXPENSES BY THE AMOUNT OF CREDIT TAKEN

In general, certain credits require that an expense be reduced by the amount of credit generated. However, other credits may require expense reduction only up to the amount of credit recognized currently. For S corporations, expense reductions will be different for the amount reduced at the S corporation level and at the shareholder level.

Example J

For the Research Credit, unless an S corporation makes an election to reduce the research credit under IRC Section 280C(c), any deduction of research and experimental expenditures under IRC Section 174 or any other deduction or credit provision for research expenses or basic research payments **must** be reduced by the research credits allowable under IRC Section 41. The add-back of the research credit must be shown as a state adjustment. The taxpayer is required to attach a schedule to its tax return that lists the deduction amounts (or capitalized expenses) that were reduced by the IRC Section 41 credits.

The amount of any credit to be claimed by a California S corporation shall be limited to one-third of the amount otherwise allowable. (R&TC Section 23803(a)(1))

For TYE 12/31/2015 XYZ Electronics, a California S corporation, incurred IRC Section 174 Research and Experimental Expenditures of $950,000 and deducted the expenses under other deductions on its 2015 (100S) tax return. XYZ also reported a regular Research Credit of $100,000 in accordance with IRC Section 41. However, XYZ utilized only $33,333 ($100,000 X 1/3) of the research credit to offset its tax liability because an S corporation is limited to use one-third of the research credit. XYZ Electronics did not elect under IRC Section 280C(c) to reduce the research credit.

Therefore, to properly reflect the IRC Section 174 expenditures were reduced by the IRC Section 41 Research Credit, XYZ made a State Adjustment under "Other Additions" on its 2015 (100S) tax return to add back $33,333 of the research credit. The reduction is required regardless of whether the S corporation is able to utilize the entire credit for TYE 12/31/2015. XYZ attached a schedule to its tax return that shows a list of its IRC Section 174 expenditures and the reduction by one-third of the allowable research credit ($450,000 + 255,000 + 245,000 - $33,333 = $916,667).

XYZ Electronics also made a California Adjustment for the full amount of the Research Credit of $100,000 on Schedule K to "Ordinary Business Income (Loss)." An S corporation is allowed to pass through to its shareholders 100% of the research credit. The California Adjustment was made to reduce the amount of IRC Section 174 expenditures included in Ordinary Business Income (Loss) shown on Schedule K. The adjusted Ordinary Business Income (Loss) amount was pro-rated based on the shareholders ownership interest and pass through to the shareholders.

Note: The IRC Section 174 expenditure reduction is different at the S corporation level than at the shareholder level. The S corporation add-back of the research credit is limited to one-third of the Research Credit or $33,333 while the shareholders' add-back is the full amount of the Research Credit or $100,000.

NOTE: ((* * *)) = Indicates confidential and/or proprietary information that has been deleted.

Revised Date: December 2018