



Special Report – Latest Developments in California and Other State Research Credits

California & Pacific Southwest Regional
State Tax Seminar
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Learning Objectives

- *Obtain a general understanding of federal research credit computation on which most state specific research credits are based*
- *Increase familiarity with key issues and common areas of non-conformity to the federal research credit on a multistate basis*
- *Deepen understanding of unique aspects and nuances of California's research credit and obtain an update on recent audit and controversy activity*
- *Gain general understanding of recently enacted California Tax Credits and Exemptions*



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Agenda

- Federal Research Credit Basics
- Multistate Research Credit Background and Overview
- California Research Credit Deep Dive
- Recent California Tax Credits and Exemptions



Federal Research Credit Basics



Federal Research Credit Basics

Three main recent version of credits:

1. Regular Credit
2. Alternative Incremental Credit (AIC)
 - ✓ Election to claim AIC expires for tax years after 12/31/2008
3. Alternative Simplified Credit

Historical Research Credits – Before Regular Credit

- Three year rolling average base period



Federal Research Credit Basics

Regular Credit

- 20% of QRE in excess of “Base Amount”
 - The formula works as follows:
 1. $84 - 88 \text{ QRE} / 84 - 88 \text{ Gross Receipts} = \text{FB\%}$
 2. $\text{FB\%} \times \text{Average prior 4 year receipts} = \text{Base Amount}$
 3. $(\text{Current year QRE} - \text{Base Amount}) \times 20\%$
- Items to consider
 - Definition of QRE
 - Start up company election
 - Max FB% of 16%
 - 50% limitation on current year QRE



Federal Research Credit Basics

Alternative Simplified Credit

- Uses discounted rolling 3 year average base period
 - The formula works as follows:

Current Year QRE

less

Average QRE from prior 3 years x 50% discount

X

14% Credit Rate

- Federal Items to consider:
 - Credit rate increase being considered by Congress
 - 6% credit rate for companies with \$0 of QRE in 1 of 3 base years



Federal Research Credit Basics

IRC 41 (b) and 41 (d)

- Generally defines a QRE
 - Wages
 - Supplies
 - Contract Research (at 65%)
- Federal Items to consider:
 - How are qualified wages tracked? By project?
 - Is the Contract Research performed in the US



Federal Research Credit Basics

IRC 41 (c)

- Defines the 'Base amount' for Regular Credit
- Provides limitations for Regular Credit
- Outlines Fixed Base % computation for existing and start up companies
 - 84 to 88
 - New company treatment
- Federal items to consider:
 - Consistent accounting treatment of expenses required
 - Election must be made on original return
 - Election is binding



Federal Research Credit Basics

IRC 41 (f)

- Aggregation of credit for entities with common ownership
 - More than 50% ownership
 - Different from federal consolidated group
- Allocation amongst group members
- Treatment of Acquisition and Disposition QRE
- Treatment of partnerships
- Termination provisions



Multistate Research Credit Background and Overview



State Research Credit Overview

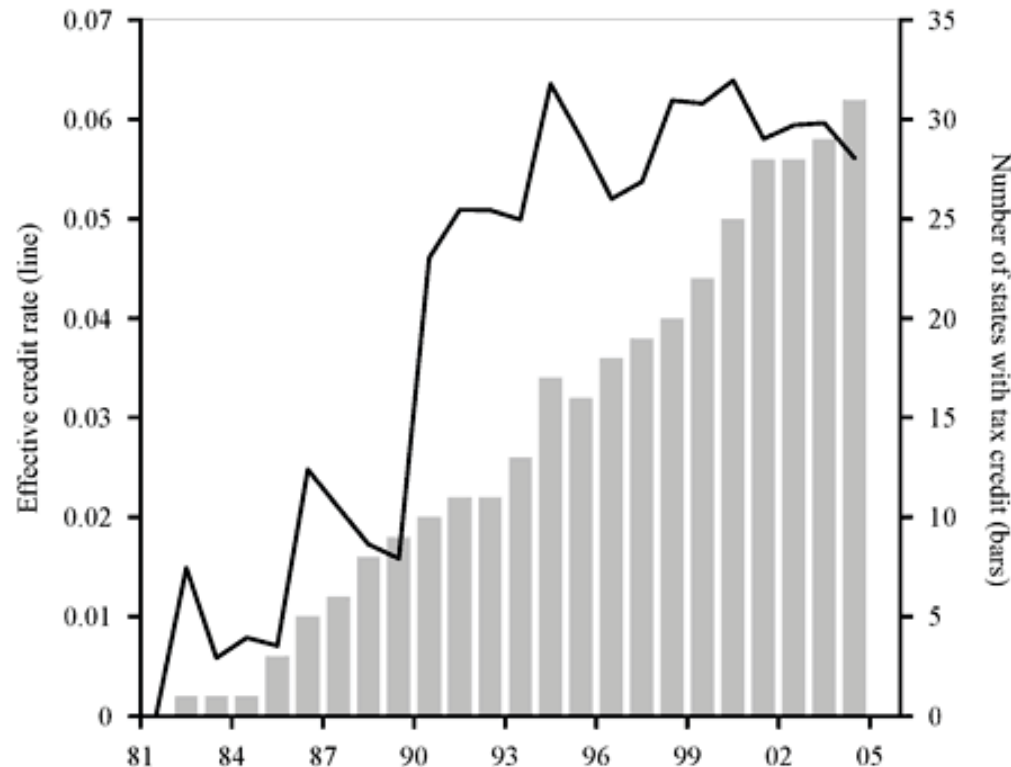
Historical Overview

- 1981 - Federal research credit first adopted
- 1982 – MN becomes first state to adopt state level research credit
- Current – 34 states with general research credit
 - Number of others with credit for specific activities / industries
 - Frequently more lucrative than federal credit per \$ of QRE in a number of states, including AZ, CA, and UT
 - Trend toward increasing credit rates – see slide on next page



State Research Credit Evolution Historical Overview

Figure 1. Rising Value and Spread of State R&D Tax Credits



Source: Author's calculations.

Source: *Economic Letter*, Federal Reserve Bank of San Francisco, 10/14/05



State Research Credit Evolution

Historical Overview

Arizona
Arkansas
California
Colorado
Connecticut
Delaware
Florida
Georgia
Hawaii
Idaho
Illinois
Indiana

Iowa
Kansas
Kentucky
Louisiana
Maine
Maryland
Massachusetts
Michigan
Minnesota
Montana
Nebraska
New Jersey
New York

North Carolina
Ohio
Pennsylvania
South Carolina
Texas
Utah
Washington
West Virginia
Wisconsin



Federal-State Conformity

- Most states have enacted some form of research activity – related tax credit since research related jobs are highly coveted by the states.
- Most credits are based to one degree or another upon the federal IRC § 41 research credit, although there are, in many cases, significant differences.
 - Nonconformance to IRC § 41(h) termination provision
 - Nonconformance to IRC § 41(f) aggregate controlled group computation
 - Nonconformance to AIRC and ASC computation methodologies
- As would be expected, most state credits are limited to in-state research activities.



Federal-State Conformity

In addition state credits may differ from the federal research credit in the following areas:

- Differing definitions of qualified research activity – for example some states base the credit on the more expansive definition under IRC § 174 or limit the credit to certain industries.
- Some states provide for the refundability and/or transferability of their credits.
- State credit expiration periods can differ significantly – i.e. many state credits are permanent and do not have specific “sunset dates,” unlike the federal credit.



Federal-State Conformity

- State determination of the incremental research eligible for credit can differ significantly – e.g. as to how the base period is defined.
- State credit carryover periods differ.
- Many states limit credit utilization to a percentage of tax liability.
- Certain states require pre-certification or special filings in order to obtain credits which , if not timely complied with, can jeopardize the ability to claim credits.

In addition to research credits, states may offer other incentives – e.g. investment tax credits, job credits, etc.



State Specific Issues / Updates

- California – nonconformity to various federal definitions; separate assignment rules, numerous other state specific issues / rules (as addressed in detail in next section.)
- Texas offers a research credit effective for reports due on/after January 1, 2014
- Florida research credit is due March 20 each year
- Nebraska – New 20 year carryforward period
- Minnesota – Changed from a refundable research credit into a credit that can be used against the entire combined groups liability (no longer refundable)
- Maryland – New law took effect on June 30, 2013 that increases annual R&D credit cap from \$6M to \$8M and allows the credit to be refundable for eligible small businesses (net book value under \$5M)
- Alternative Credit Elections in Certain States



California Research Credit Deep Dive



California Research Credit

- CRTC § 23609 provides for a research credit which is based on the IRC § 41 credit subject to specific modifications
- The rate of the general credit is 15% (vs. 20% for federal)
- The rate of the basic research credit is 24% (vs. 20% for federal)
- “Qualified research” and “basic research” is limited to research conducted within California
- Unused research credits may be carried over indefinitely
- The California credit is permanent



General Credit Calculation

- Like the federal credit, the general credit calculation in California is based upon the excess of California qualified research expenditures over a base amount
- Similar to federal, the base amount is equal to the fixed base percentage multiplied by the average annual gross receipts for the four preceding tax years



General Credit Calculation

- Fixed base percentage equals:
$$\frac{\text{Aggregate QRE for tax years beginning after 12/31/83 and before 1/1/89 (i.e., 1984 – 1988)}}{\text{Aggregate gross receipts for the same period}}$$
- Unlike federal, gross receipts for purposes of the Base Period % as well as the average annual gross receipts amount is limited to gross receipts from the sale of property held for sale which is shipped to purchasers in the state.
 - Service receipts generally excluded
 - Interest and dividends excluded
 - “Throwback” does not apply to sales shipped to “no nexus” states
 - Origin sourcing of US Government sales does not apply
- Base period % is limited to 16%
- Base amount is not less than 50% of QRE



California Comparison to Federal (Example)

	<u>FED</u>	<u>CA</u>
QRE	\$2 Million	\$2 Million
Average Annual Receipts	\$200 Million	\$5 Million
Base Period QRE	\$500,000	\$500,000
Base Period Receipts	\$50 Million	\$2 Million
Base Period %	1%	16%
Computed Base	\$2 Million	\$800,000
Minimum Base	\$1 Million	\$1 Million
Incremental QRE	\$0	\$1 Million
Credit	\$0	\$150,000



California Comparison to Federal (Example – Cont.)

- As illustrated above, because the Base Period % is capped at 16% and receipts are limited to California receipts from the sale of property, it is not uncommon for companies to have incremental QREs for California purposes, even in cases where research as a percentage of overall sales remains static or is declining.
- Like federal, the California credit is computed on a controlled group basis.
 - Unitary / non-unitary determinations don't directly impact the calculation even where there are multiple combined filings in California.



Other Credit Calculation Methods

- California conforms to the startup company calculation method
 - Note that due to the California definition of receipts and QRE it is possible that some companies may be required to use this method for California purposes but not for federal.
- California conforms to the Alternative Incremental Research Credit or “AIRC” method but applies lower credit percentages.
 - Note that while severely base limited companies may elect AIRC for federal, separate elections are allowed in California and the AIRC election may not be favorable.
- California does not currently conform to the alternative simplified credit method.



Impact of IRC §280C Election

- Where an IRC § 280C election is made, taxpayer takes a reduced credit but preserves a full deduction for its research expenses
 - Absent an IRC § 280C election, taxpayer disallows a research expense deduction in an amount equal to the credit
- For federal purposes, electing the reduced credit versus disallowing research expense deduction equal to the credit amount is often (but not always) a wash
 - Foregoing an IRC § 280C for federal purpose can be advantageous due to effect on foreign tax credit utilization, alternative minimum tax computation, etc.
- For California purposes, electing the reduced credit effectively disallows a deduction equal to 100% of the credit; whereas forgoing the election disallows such a deduction *only to the extent of the California apportionment factor*
 - This occurs because the deduction is disallowed on a *pre-apportionment* basis



Impact of IRC §280C Election

- Example
 - \$5M CA Research Credit
 - 15% CA Apportionment Factor

CA NET RESEARCH CREDIT BENEFIT		
FOREGO 280C REDUCED CREDIT ELECTION		
<u>w/ 280C Election</u>		
Regular Credit	5,000,000	
Reduced Credit @ 91.16%	4,558,000	
Reduction in Credit		442,000
<u>w/o 280C Election</u>		
Addback Research Expense	5,000,000	
CA Appt. Factor	15.0%	
Tax Rate	8.84%	
Increase in CA Tax Liability		66,300
Difference		375,700

- Separate elections are allowed in California and an IRC § 280C reduced credit election is seldom advisable for California purposes.



Credit Utilization Limitations

- Historically, the California research credit (as well as a number of other credits) could reduce regular tax below the tentative minimum tax, but could not reduce the AMT itself, which is a separate tax amount determined before credits:

TMT	\$1,200,000
Reg. Tax Before Credit	\$1,000,000
AMT	\$ 200,000
Research Credit	\$1,500,000
Tax:	
Reg.	\$ 800 (min. tax)
AMT	<u>\$ 200,000</u>
Total Tax	\$ 200,800
Research Credit C/F	\$ 500,800



Credit Utilization Limitations

- *Appeal of NASSCO Holdings, Inc.*, 2010-SBE-001 (Nov. 12, 2010)
 - BOE ruled NASSCO Holdings could utilize Enterprise Zone (EZ) and Manufacturers Investment (MIC) credits to offset its Alternative Minimum Tax (AMT)
 - FTB's long-standing position was that credits could only offset a taxpayer's regular tax liability down to the \$800 minimum tax
 - Taxpayer prevailed arguing the FTB was denying taxpayers the very benefit the Legislature had intended
 - FTB has issued guidance that it will treat the NASSCO decision as only applying to EZ and MIC (and not research credit), FTB Notice 2011-02 (Mar. 18, 2011)



Credit Utilization Limitations

- The California Supreme Court held in *General Motors v. FTB*, California Supreme Court (2006) that research credits are entity specific within combined groups and may not offset tax liability of other group members – But see Credit Assignment discussed below
- AB 1452 caps the amount of business tax credits that can be claimed to 50% of the taxpayer's liability for taxable years beginning on or after January 1, 2008 and before January 1, 2010. (i.e. Credits can reduce tax liability by a maximum of 50%.)
- Credit limitation is on an entity by entity basis
- The amount of the credit disallowed because of the 50% limit will be allowed as a carryover
- The carryover period for any credit not allowed will be increased by the number of taxable years the credit is not allowed



Credit Assignment

- For tax years beginning on or after July 1, 2008, any “eligible credit” may be assigned to any “eligible assignee”
 - “Eligible credit” means any credit earned on or after July 1, 2008, as well as any credit earned prior to July 1, 2008, that is eligible to be carried forward to the first tax year beginning on or after July 1, 2008
 - “Eligible assignee” means any affiliated corporation properly treated as a member of the same unitary group
- A credit assigned may be applied only by an eligible assignee against its tax liability in tax years beginning on or after January 1, 2010



Credit Assignment

- Credits earned before July 1, 2008 may be shared if the assignee was unitary with the assigning corporation as of:
 - June 30, 2008, and
 - The last day of the tax year for which credits were assigned
- Note:
 - Assignee sold prior to the last day of combined group's tax year will not qualify
 - If not instantly unitary as of the end of the year, will not qualify
 - Cannot share pre-July 1, 2008 credits with companies acquired and unitary on or after July 1, 2008



Credit Assignment

- Payments to purchase credits
 - Are not deductible by the payor, and
 - Are not income to the recipient
- Both parties are liable for any tax, so if the FTB loses statute on one party it can still collect against the other
 - May want a tax sharing agreement
- An election to assign credit is irrevocable once made
- Taxpayer assigning credit shall reduce the amount of its unused credit and the amount is no longer included as a carryover



Credit Assignment

- Do not need to assign the entire amount of credits available. Taxpayer can retain carryover balance and decide later whether and to which entity to assign additional credits
- The assignee may not sell or otherwise transfer the assigned credit to any other taxpayer
- The election and assignment is made on FTB Form 3544, *Election to Assign Credit Within Unitary Group*



Audit Activity and Issues

- Research credit is area of increased focus following expiration of the MIC and unfavorable EZ credit precedents
- FTB has created a specialist team and is conducting general audit training in this area
- Key areas of focus:
 - Challenging QREs on various grounds, including re-audit of federal audit results where FTB is not satisfied with degree of IRS audit scrutiny
 - QRE geography, especially contract research component
 - Separate audit of CA base period computation
 - Summarily disallowing any “pre-packaged study” for lack of contemporaneous documentation



BOE Cases

Pacific Southwest Container, Inc. (“PSC”), BOE Case No. 473587
(March 22, 2011)

- All previous research credit appeals to the BOE have been rejected by the BOE.
- The BOE rules in favor of the California Franchise Tax Board 90% of the time.
- Background –
 - Appeal arose from a claim for refund for research credits denied by the California FTB
 - FTB conceded that PSC conducted research, but denied 80% of the refund



BOE Cases

Pacific Southwest Container (“PSC”) (cont.)

- Issues – did PSC conduct qualified research and did they substantiate amounts claimed?
- Background of PSC
- Legal background
- PwC research credit study was central to case
- BOE agreed with PSC, on a 5-0 vote, that
 - PSC engaged in qualified research
 - The PwC study complied with substantiation requirements
 - That the FTB failed to provide any evidence that impeached the results of the study
 - Summarily denying the results of any “pre-packaged” study for lack of contemporaneous documentation



BOE Cases

Pacific Southwest Container (“PSC”) (cont.)

- Why did BOE uphold PSC’s appeal
 - The PwC study tied activities to business components (projects)
 - BOE agreed that cost center based approaches are acceptable
 - The study included contemporaneous business records (engineering drawings and test data) tied to contemporaneous financial records
 - The study “validated” conclusions by gathering and reviewing records on a sufficient number of projects



BOE Cases

Pacific Southwest Container (“PSC”) (cont.)

- Why did the BOE reject FTB’s arguments
 - The FTB was unfamiliar with the contents of the study
 - The FTB merely criticized the study methodology, without gathering specific evidence that would impeach the study
 - The FTB did not conduct any interviews
 - The FTB did not disagree that the projects they sampled qualified for the credit
 - The FTB could not support their arbitrary allowance of 20% of the credit



BOE Cases

Pacific Coast Building Products, Inc., BOE Case No. 514183 (Feb. 25, 2014)

- Issues – (1) did taxpayer conduct qualified research; (2) did taxpayer prove qualified research expenses; (3) did taxpayer substantiate its fixed-based percentage as required by IRC § 41(c)(3)(A)
- Two oral hearings
- In a summary decision, the BOE found that:
 - The taxpayer demonstrated that its activities were qualified activities through contemporaneous and other documentation as well as oral testimony
 - The taxpayer established a nexus between the qualified research and a substantial portion of the claimed expenses



BOE Cases

DreamWorks Animation SKG, Inc., BOE Case No. 717701 (2013)

- Whether film production employees who were an integral part of the taxpayer's software development process performed qualified services as defined in IRC § 41.
- FTB conceded that employees in the R&D department and employees in the production department who were listed on patents performed qualified services.
- After the filing of appellant's opening brief and several discussions between the parties, the FTB conceded the case.



FTB Legal Guidance

- In June 2011, FTB issued Legal Division Guidance 2011-06-01
 - Purely service company with no “gross receipts” from sales of tangible personal property could not claim the R&D credit
- In July 2011, LDG 2011-06-01 withdrawn
- In March 2012, FTB issued LDG 2012-03-01
 - Taxpayers with no “gross receipts” under RTC § 23609(h)(3) can claim the R&D credit



Federal Determination

FTB following federal determination

- In November 2013, FTB Chief Counsel indicated that the FTB generally will follow federal determinations on research credits where California law conforms to federal law
- In its December 2013 issue of *Tax News*, the FTB confirmed that in order to improve and streamline R&D cases, if the IRS audited the R&D credit, the FTB will generally follow the federal determination. However, the FTB may need to request information to determine how to apply the IRS analysis to California research.



Other Recent California Credits and Exemptions



Governor's Economic Development Initiative

- Elimination of Enterprise Zone Hiring Credit
- Creation of:
 - California Competes Credit
 - New Employment Credit
 - Partial Manufacturing Sales and Use Tax Exemption



California Competes Credit

- Minimal eligibility requirements
- Two-phase application process
- Special handling of “retention only” applicants
- Credit allocation negotiated with Go-Biz
- Formal credit allocation agreement entered into with Go-Biz
- Public disclosure of agreement
- Trade secret and other confidential information protection



New Employment Credit

- Must hire full-time employees
- Credit of up to 35 percent of qualified wages between 150-350 percent of the state minimum wage for period of 5 years
- Only available if employer increases California jobs
- Only for hiring of certain types of employees (unemployed, veterans, ex-offenders, recipients of general assistance)
- Only for employment conducted primarily within designated zones (impoverished and high unemployment areas)
- Retailers, temporary help services, and restaurants are ineligible
- Credit must be claimed on original timely filed return
- Credit request must be reserved with the FTB within 50 days of hire



Manufacturing Sales and Use Tax Exemption

- Partial exemption of state sales tax on qualified purchases
- Annual maximum of \$200 million in qualified purchases (includes purchases of all combined report members)
- Qualified person – either a legal entity or an establishment
- Qualified property – used in manufacturing process
- Partial exemption certificate
- Financial, agricultural, and extractive businesses that are required to apportion income under California Revenue & Taxation Code § 25128(b) are ineligible for exemption.