

Franchise Tax Board California Competes Tax Credit Review Procedures

By Michael J. Cataldo and Paul T. Casas

The Franchise Tax Board will begin reviewing California Competes Tax Credit agreements of most credit recipients in July of this year, and may recommend recapture of the credit if recipients fail to meet the conditions set forth in those agreements.

Introduction

The Governor's Office of Business and Economic Development ("GO-Biz") is authorized to annually allocate a limited amount of the California Competes Tax Credit.¹ Taxpayers may apply for the credit by submitting detailed information about their businesses to GO-Biz during open application periods. If ultimately selected for a credit allocation, taxpayers must enter into a written credit agreement with GO-Biz to provide certain levels of California employment and investment.²

All credit agreements must contain a credit recapture provision, which may be triggered if the taxpayer fails to achieve the agreed upon California employment and investment levels.³ The Franchise Tax Board ("FTB") is responsible for reviewing taxpayer books and records to verify compliance with those agreements, and for recommending credit recapture to the California Competes Tax Credit Committee ("Committee").⁴ The Committee, not the FTB, is ultimately responsible for determining whether and to what extent credit must be recaptured.⁵

¹ The California Competes Credit is a negotiated income or franchise tax credit available to most any business. See our client alerts dated [December 4, 2013](#), [February 11, 2014](#) and [March 20, 2014](#) for details on credit eligibility and the application process.

² Section 18410.2(b)(1). All statutory citations are to the California Revenue and Taxation Code.

³ Sections 17059.2(d)(1)(A) and 23689(d)(1)(A).

⁴ Sections 17059.2(a)(3) and 23689(a)(3).

⁵ Section 18410.2(b)(2).

Credit Agreement Review Procedures

FTB is required to review the books and records of *all* taxpayers (other than small businesses)⁶ that receive the California Competes Tax Credit to ensure compliance with their credit agreements.⁷ If FTB determines during the course of its review that there has been a possible material breach of the credit agreement, it must notify GO-Biz and provide it with detailed information regarding the basis of that determination.⁸

FTB has sole discretion to determine the form and manner of credit agreement reviews,⁹ and, during the course of its reviews, will have access to all information provided by taxpayers to GO-Biz during the credit application process.¹⁰ The reviews are not considered an audit of a tax return, and do not preclude the FTB from conducting an audit of the taxpayer in the ordinary course.¹¹

FTB Notice 2014-02 sets forth the general procedures applicable to FTB's review of taxpayer compliance with credit agreements. Thereunder, FTB will conduct the review in a reasonable, timely, and practical manner, and make relevant and reasonable information requests related to compliance with the credit agreement.¹² Information requests are relevant if the requested information is germane to or applicable to the credit agreement.¹³ Upon request, FTB will explain the relevance or reasonableness of information requests.¹⁴ Taxpayers must maintain relevant records and documents pursuant to normal accounting or regulatory guidelines to the extent they are applicable to the credit agreement under review.¹⁵

FTB will perform either a field review or a desk review, and will determine which type of review is appropriate by considering factors such as the size of the business, dollar amounts involved, and the complexity of the credit agreement.¹⁶ Field reviews will generally take place where the taxpayer's original books, records, and documents relevant to the review are maintained.¹⁷ Desk reviews will be conducted primarily through mailed correspondence.¹⁸ Regardless of the type of review, FTB may make onsite visits if needed to establish facts that require a visual inspection (e.g., to verify the existence and location of assets).¹⁹

During an FTB Interested Parties Meeting ("IPM") held on February 19, 2015, regarding FTB's credit agreement review procedures, several attendees expressed concern that information provided to FTB in the course of the credit agreement review might lead to an unrelated income or franchise tax audit. FTB indicated that information requested in the course of credit agreement reviews would be focused on whether the taxpayer is in compliance with the credit agreement, and that taxpayers should inquire with the reviewer or the reviewer's supervisor if an information request does not appear relevant to that end. Note that nothing prohibits FTB from using the information gathered for purposes of its credit agreement review in a subsequent income or franchise tax audit. Taxpayers should keep in mind that any information provided to GO-Biz during the credit application and negotiation process will be accessible to the FTB, and may be used for FTB income or franchise tax audits unrelated to the credit agreement review.

⁶ FTB is not required to review the books and records of "small businesses," but may do so in its sole discretion. Sections 17059.2(d)(1)(B) and 23689(d)(1)(B).

⁷ Sections 17059.2(d)(1)(A) and 23689(d)(1)(A).

⁸ Regulation 8040(e). All regulatory citations are to Title 10 of the California Code of Regulations, promulgated by Go-Biz.

⁹ Regulation 8040(d).

¹⁰ Regulation 8040(a).

¹¹ Regulation 8040(d).

¹² Notice, section (a)(5)(A) and (B).

¹³ Notice, section (a)(5)(B)(2).

¹⁴ Notice, section (a)(5)(B)(1).

¹⁵ Notice, section (a)(6).

¹⁶ Notice, section (b)(1).

¹⁷ Notice, section (b)(2)(B).

¹⁸ Notice, section (b)(3).

¹⁹ Notice, section (b)(2)(C).

FTB also indicated at the IPM that it will focus on two general areas in the course of its review of credit agreements: (1) increases in employment and compensation levels, and (2) project investments. For increases in employment and compensation levels, FTB stated that it may request payroll reports and records to support hours worked, dates of hire, wage and salary levels, and other paid compensation. For project investments, FTB stated that it may request onsite visits, as well as documentation, such as:

- authorization for expenditures, invoices, deeds, contracts, rental and lease agreements
- construction showing property descriptions, designs, and costs
- patent application packets and patent logs
- lists of depreciable asset costs, and dates purchased and placed in service
- summary analyses of property, plant and equipment
- Board of Directors meeting minutes authorizing expenditures
- blueprints and architectural designs
- invoices for self-constructed assets
- general ledger records

FTB will look to the terms of each individual credit agreement to determine if a material breach has occurred. For example, FTB stated at the IPM that a material breach occurs if the taxpayer fails to satisfy a milestone set forth in the credit agreement. FTB may also determine there has been a material breach of the credit agreement if the taxpayer is unable or fails to provide relevant information requested in the course of FTB's credit agreement review.²⁰ FTB may notify GO-Biz of a possible material breach of the credit agreement if the taxpayer fails to provide timely and complete responses to information requests, but will exercise discretion in a reasonable manner that is appropriate under the relevant circumstances related to that particular review before doing so.²¹ FTB stated at the IPM that a material breach may also occur if there is a significant delay in response to information requests from the FTB in the course of its credit agreement review, or if the taxpayer made a significant misstatement to GO-Biz during the credit application and negotiation process.

Credit Recapture

After FTB completes a credit agreement review, it will issue a letter to the taxpayer and GO-Biz stating that the taxpayer is either in compliance with the agreement, or that it has materially breached the agreement.²² If FTB finds that the taxpayer has materially breached the credit agreement, it will provide GO-Biz detailed information regarding the basis thereof, and Go-Biz shall provide its recapture recommendation to the Committee.²³ If the Committee determines some or all of the credit will be recaptured, the taxpayer and the FTB will be notified of the amount to be recaptured.²⁴ The amount of tax resulting from any credit recapture will be added to the tax otherwise due by the taxpayer for the taxable year in which the Committee's recapture determination occurs.²⁵

²⁰ Notice, section (a)(6).

²¹ Notice, section (b)(5)(C)(2).

²² Notice, section (b)(5)(H).

²³ Regulation 8040(e).

²⁴ Sections 17059.2(c)(4) and 23689(c)(4).

²⁵ Sections 17059.2(f) and 23689(f).

Taxpayer Recourse


Taxpayers may request a closing conference to discuss an FTB finding that the credit agreement has been materially breached, but have no other immediate means to contest such a finding.²⁶ However, aggrieved taxpayers are not entirely without recourse. The Committee is ultimately responsible for deciding whether credit recapture is required at a duly-noticed public meeting, and is not bound by FTB's findings.²⁷ According to a GO-Biz representative present at the IPM, taxpayers will have an opportunity at this public meeting to contest FTB's findings, and to submit additional information to the Committee in support of their position.

If the Committee decides some or all of the credit will be recaptured, taxpayers will be billed for any resulting tax, and will have no pre-payment right to protest or appeal the Committee's decision.²⁸ However, FTB noted at the IPM that taxpayers may contest the Committee's recapture decision by filing a claim for refund after paying such additional tax. FTB would likely deny a refund claim contrary to its own credit agreement review findings, and taxpayer would then have the right to seek review of the FTB's refund claim denial before the State Board of Equalization and/or the Superior Court.

Concluding Remarks

Determining whether a taxpayer has materially breached its credit agreement will be an inherently subjective inquiry. Taxpayers, FTB, and the Committee will often disagree on what might constitute a material breach given the lack of meaningful guidance thus far. The options for an aggrieved taxpayer to contest an adverse credit recapture decisions are also unclear. How these potential issues may play out is yet to be seen, but we should learn more after the first round of FTB credit agreement reviews this summer. We will keep you posted.

The information presented is only of a general nature, intended simply as background material, is current only as of its indicated date, omits many details and special rules, and accordingly cannot be regarded as legal or tax advice.

²⁶ Notice, section (b)(5)(G).

²⁷ Section 18410.2(b)(2).

²⁸ Sections 17059.2(f) and 23689(f).

If you have any questions about the content of this alert, please contact one of the authors, the Pillsbury attorney with whom you regularly work, or one of the attorneys below.

Michael J. Cataldo [\(bio\)](#)
San Francisco
+1.415.983.1954
michael.cataldo@pillsburylaw.com

Jeffrey M. Vesely [\(bio\)](#)
San Francisco
+1.415.983.1075
jeffrey.vesely@pillsburylaw.com

Kerne H. O. Matsubara [\(bio\)](#)
San Francisco
+1.415.983.1233
kerne.matsubara@pillsburylaw.com

Annie H. Huang [\(bio\)](#)
San Francisco
+1.415.983.1979
annie.huang@pillsburylaw.com

Paul T. Casas [\(bio\)](#)
San Francisco
+1.415.983.1019
paul.casas@pillsburylaw.com

Richard E. Nielsen [\(bio\)](#)
San Francisco
+1.415.983.1964
richard.nielsen@pillsburylaw.com

About Pillsbury Winthrop Shaw Pittman LLP

Pillsbury is a full-service law firm with an industry focus on energy & natural resources, financial services including financial institutions, real estate & construction, and technology. Based in the world's major financial, technology and energy centers, Pillsbury counsels clients on global business, regulatory and litigation matters. We work in multidisciplinary teams that allow us to understand our clients' objectives, anticipate trends, and bring a 360-degree perspective to complex business and legal issues—helping clients to take greater advantage of new opportunities, meet and exceed their objectives, and better mitigate risk. This collaborative work style helps produce the results our clients seek.