Numerous states offer a research and development ("R&D") tax credit. Companies can, therefore, claim credits for the same expenditures in different jurisdictions. Similar to enterprise zone credits and job training credits, the purpose behind state research tax credits is to incentivize companies to invest and provide jobs in a given state. Frequently these states follow federal guidance under Sections 41 and 174 of the Internal Revenue Code and accompanying regulations. California largely conforms to the federal credit guidelines with a number of critical adjustments.

California has historically enacted incremental changes to make its R&D credit more attractive to businesses. These include businesses in the biotech, agriculture, technology, software, manufacturing, pharmaceutical, pre-release medical device and aerospace industries. As such, it is important to understand the differences between the federal and California R&D tax credit to successfully claim the benefit in both jurisdictions. Thankfully, the State Franchise Tax Board has published the "Research & Development Credit: Frequently Asked Questions." This is a very helpful information source whenever filing for a California Research Credit.

Overview

As with the IRC Section 41 federal R&D tax credit, California provides a permanent tax credit as an incentive for taxpayers to conduct R&D activities. The California R&D Credit reduces income or franchise tax. Qualified research must occur in California to qualify for the California credit. Qualified Research Expenditures ("QREs") generally include wages, supplies and contract research costs. As with the federal credit, the calculation in California is based upon the excess of California QREs over a base amount. The regular credit base amount means the product of the fixed base percentage and the average annual gross receipts for the four preceding tax years.

Start-Up Companies

California follows the federal rules for determining the fixed--based percentage. A start--up company is one that had both qualified California research expenses and gross receipts either for the first time in a taxable year beginning after December 31, 1983 or for fewer than three taxable years beginning after December 31, 1983, and before January 1, 1989. The fixed--base percentage for a start--up company is 3 percent for each of the company's first five taxable years beginning on or after January 1, 1994, that the company has a qualified research expenses. There is a ten--year phase--in period leading up to a permanent fixed base percentage calculation based on five contiguous years of experience during the 6th through the 10th year. A progressively increasing rate applies during the period between the 6th and 10th year.

Meeting the Four-Part Test

Per California Revenue and Taxation Code Sections 17052.12 (Personal Income Tax) and 23609 (Corporation Tax), for an activity or project to qualify for the research credit, the taxpayer must show that it meets all of the requirements in Internal Revenue Code § 41(d). In order to claim the research credit, the research activity must satisfy a four--part test:

- The research must have qualified as a business deduction under IRC §174.
- The research must be undertaken to “discover information which is technological in nature.”
The taxpayer must intend to use the information to develop a new or improved business component

The taxpayer must pursue a “process of experimentation” during substantially all of the research

Deviations from Federal R&D Law

While the California and federal credits share numerous common requirements, the California R&D Credit has some distinct characteristics. For example, the credit rate in California is 15 percent as opposed to 20 percent for federal purposes when using the regular calculation method. California does not conform to the federal Alternative Simplified Credit Method, but allows an election for the Alternative Incremental Research Credit (a method no longer available for the federal credit). Unused California research credits can be carried forward indefinitely as opposed to federal credits which can be carried back one year and carried forward twenty years. The California research credit also covers 24 percent (20 percent for federal purposes) of certain basic research payments to qualified organizations (e.g., universities and non-profit scientific research organizations).

Gross Receipts

One of the key differences between the federal and California R&D credit is the definition of gross receipts. This issue is often overlooked by taxpayers. California has a very specific and limited definition of gross receipts. California gross receipts only include sales of real, tangible, or intangible property held for sale to customers in the ordinary course of the taxpayer’s trade or business delivered or shipped to a purchaser within California. This includes sales to the U.S. government which can be identified as delivered in California. Excluded receipts include receipts from services, rents, operating leases, and interest.

Like the federal credit, under the regular California R&D credit calculation method, QREs are reduced by the calculated base amount determined by a percentage of average gross receipts for the four years prior to the year of the credit. As pure service firms and software licensors are often considered not to have California gross receipts, these businesses would be unable to calculate a fixed base to claim the California credit using the gross receipts method. However, Legal Division Guidance 2012-03-01 issued by the California Franchise Tax Board (“FTB”) clarifies that such companies can utilize a minimum fixed base equal to 50 percent of their R&D expenditures in the year of the credit claim. Thus, even absent any gross CA receipts, service firms and software licensors can still calculate a fixed base and claim the California Regular R&D credit.

So, what is the practical impact? Taxpayers should expect the fixed base percentage to differ for federal and California computations. This also means that average gross receipts for the preceding four years may significantly vary. Moreover, the minimum fixed base for California can provide a large and often beneficial difference to the taxpayer.

Alternative Incremental Research Credit

Another key difference between the federal and California credit regimes is that California does not conform to the federal Alternative Simplified Method (“ASC”), but instead allows an election for the Alternative Incremental Research Credit (“AIRC”). In California, a company can elect to claim either the regular Research Credit or the AIRC. When claiming the regular research credit, if the base amount is higher than the current qualified research expenses, the company may not qualify for credit. If so, the company may be eligible to receive a less rewarding benefit under the AIRC. The AIRC provides an alternative for those who do not have an incremental increase under the regular method.

Credit rates and base amounts under the California AIRC method are as follows:

- A credit rate of 1.49 percent applies to the extent that a taxpayer’s current–year research expenses exceed a base amount computer by using a fixed–base percentage of 1 percent but does not exceed a base amount computed by using a fixed–base percentage of 1.5 percent;
- A credit rate of 1.98 percent applies to the extent that a taxpayer’s current–year research expenses exceed a base amount computed by using a fixed–base percentage of 1.5 percent but does not exceed a base amount computed by using a fixed–base percentage of 2 percent; and
- A credit rate of 2.48 percent applies to the extent that a taxpayer’s current–year research expenses exceed a base amount computed by using a fixed–base percentage of 2 percent.

Taxpayers must make an election to use the alternative incremental credit on a timely filed original return. Again, since the AIRC
provides a modest benefit, it is almost always more beneficial to claim the regular credit.

**280C(c) Election**

For federal tax purposes, IRC §280C(c) disallows a research expense deduction under IRC §174 for the taxable year equal to the amount equal to the R&D Credit determined for the year. This prevents the taxpayer from receiving a tax benefit for the expenses twice. The disallowance creates an addition to income in the amount of the credit in order to decrease the IRC §174 R&D expense deduction. A taxpayer may make an IRC §280C election to receive a reduced credit, but preserves a full deduction for its research expenses.

Under Revenue & Tax Law §24440, California conforms to the disallowance under IRC §280C(c). California taxpayers may avoid the reduction of their R&D expenses by electing to take a reduced credit in accordance with IRC §280C. Since separate elections are allowed in California, taxpayers are not required to make an election for reduced credit in California, even if an election was made for federal purposes.

The maximum tax rates are used for computing the California research credit with a § 280C election. On FTB Form 3523 Research Credit, corporations making the § 280C election multiply their research credit by 91.16 percent, individuals and estates or trusts multiply their research credit by 87.7 percent, and S corporations multiply their research credit by 98.5 percent to arrive at the reduced credit amount. This irrevocable election must be made on the original California return filed on or before the due date for filing the return, including extensions.

**Claiming the Credit**

Companies can claim the California R&D Credit using FTB Form 3523, Research Credit, for the year qualified R&D expenses were paid or incurred in California. California’s R&D Credit is not a refundable credit; whereas the federal research credit is refundable under certain circumstances under IRC§ 41(h) through a payroll tax offset. Any California R&D Credit that is not used to offset the qualified taxpayer’s income or franchise tax must be carried over to future years.

For companies who file on a combined group basis, all members of the combined group must use the same method. To compute either the regular Research Credit, or the AIRC, all members of a “controlled group” are to be treated as a single taxpayer. The “controlled group” is not necessarily restricted to the entities included in the combined report and may include non—unitary affiliates. It may also include multiple combined reporting groups. For both federal and California purposes, credit documentation is aggregated from all members of a controlled group to compute the credit as a single taxpayer. This credit amount is then divided and proportionately allocated back to each member of the controlled group.

**Amending the Credit**

Taxpayers can amend a prior year California tax return to claim a qualified R&D Credit as long as the applicable statute of limitations is open. For taxable taxpayers, generally the statute of limitations is four years from the original due date of the return, or one year from the date of the overpayment, whichever period expires later. Note, the 280(C) election to reduce the credit cannot be made on an amended return.

**FTB Audit Focus**

The FTB has seen an increase in the number of R&D credits claimed where documentation of qualified expenditures has been inadequate. Key issues that are heavily audited by the FTB typically involve senior level job titles, the state location of contractors, and base period calculations. For example, auditors flag senior executive roles such as VP of Engineering and the Chief Technology Officer that are conducting qualifying activities. These roles are perceived as providing minimal development support or supervision and instead conduct more administrative tasks such as hiring or budgeting. However, if the employees in these positions are more “hands—on” and provide direct technical supervision of research, they can be claimed as qualifying if proper documentation is available to support this claim. As another example, since the definition of gross receipts is different in California, auditors often look at base period calculations to ensure gross receipts are captured correctly.

**FTB and Federal Determination**

The FTB will generally follow IRS determinations on research credits where California law conforms to federal law. However, the
FTB may audit information to determine how to apply the IRS analysis to California research. If the research activities reviewed by the IRS were substantially different from research conducted in California, the FTB may decide to further examine California research activities.

A&M Says:

The R&D tax credit can be a significant benefit for businesses in California. In fact, for many taxpayers the California research credit is superior to the federal credit. As California imposes additional requirements on the computation of the state credits, many aspects of claiming the credit can be easily overlooked. In computing the credit for both federal and California purposes, it is important to consider several variables and options such as: (1) the various methods for computing the credit; (2) the different definitions of gross receipts; (3) whether the taxpayer is a member of a group of businesses that must aggregate their activities; and (4) whether qualified contractors are conducting research in California. Strictly following the federal rules to claim California credits could erroneously forgo a substantial amount of California research credits. As such, it is important to be well-versed in the intricacies of state research credits to prevent missed opportunities. Equally important is ensuring that research activities and costs are well-documented to sufficiently support both federal and California research credit requirements.

Footnotes:

1. FTB 1082 REV 02–2008.
2. www.ftb.ca.gov/businesses/credits/rd/overview.shtml

R&D Credit – Practical Considerations After Tax Reform [2]

With all the changes associated with the Tax Cuts and Jobs Act of 2017, one pleasant constant for taxpayers is the IRC 41 Credit for Increasing Research Activities, popularly known as the R&D Tax Credit. While taxpayers can continue to rely upon the R&D Tax Credit for savings, new features of the Internal Revenue Code present some interesting considerations.

No Money, No Problem: Refundable R&D Tax Credit Opportunities for Startups and “Small” Businesses [3]

The federal research and development tax credit was finally made permanent in late 2015 under the Protecting Americans from Tax Hikes (PATH) Act.

Alvarez & Marsal Taxand Expands R&D Tax Credit Expertise with the Addition of Houston–Based TRCG Advisors [4]

Alvarez & Marsal Taxand, LLC (A&M Taxand), an affiliate of leading global professional services firm Alvarez & Marsal (A&M), announces the addition of Houston–based TRCG Advisors, a firm recognized for its tax credit and incentives transaction expertise.

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Authors:
Brett Nowak, bnowak@alvarezandmarsal.com, +1 571 278 9495