

Client Alert.

March 20, 2012

The California Franchise Tax Board Re-Issues Legal Division Guidance on the Research and Development Credit

By Eric J. Coffill and Jenny Choi

Internal Revenue Code (“IRC”) section 41 provides for a federal research and development credit for certain qualified research expenses, basic research payments, and other enumerated expenses.¹ California allows a similar, but not identical, research and development credit (“R&D Credit”) for the amounts paid or incurred for research and development in California. Generally, the California credit is allowed in accordance with IRC section 41, as modified by California Revenue and Taxation Code² sections 17052.12 (personal income tax) and 23609 (corporation tax).

Less than a year ago, the FTB issued Legal Division Guidance 2011-06-01, which addressed two questions regarding the California R&D Credit. First, it explained California does not conform to the definition of “gross receipts” set forth in IRC section 41(c)(7) because California excludes from the definition receipts that are not “sales of property....”³ Accordingly, the FTB stated that such items as throwback sales, as well as receipts from services, rents, operating leases and interest are excluded from the California definition of “gross receipts.”⁴ Second, that guidance stated that pure service companies cannot claim the California R&D Credit.⁵ The FTB took the position that a pure service company with only service receipts has no “gross receipts” as defined under section 23609. Consequently, such a company cannot establish that it correctly calculated its California base amount and fixed-base percentage – the figures used to compute the R&D Credit.⁶

A month later, and after receiving comments from the taxpayer community, the FTB issued Legal Division Guidance 2011-07-01, which withdrew Legal Division Guidance 2011-06-01. The reason stated for the withdrawal was to allow the FTB “to explore alternative methods to issue authoritative guidance,”⁷ suggesting that perhaps an FTB Legal Notice or Legal Ruling would be forthcoming.

On March 16, 2012, and after further consultation with the IRS on the nature of the federal credit, the FTB instead issued another Legal Division Guidance. Legal Division Guidance 2012-03-01 (“Guidance”) now supersedes Legal Division Guidance 2011-06-01. The Guidance reaffirmed the FTB’s prior position on California’s definition of “gross receipts” for

¹ See IRC § 41(a).

² All statutory references herein are to the California Revenue and Taxation Code, unless otherwise indicated.

³ See FTB Legal Division Guidance 2011-06-01.

⁴ See *id.*

⁵ See *id.*

⁶ See *id.* Gross receipts are used to compute both the base amount and the fixed-base percentage. (See IRC § 41(c)(1) and (3).)

⁷ See FTB Legal Division Guidance 2011-07-01.

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purposes of the R&D Credit.⁸ Looking to the language of sections 17052.12(g)(3) and 23609(h)(3), the FTB states in the Guidance that California's definition of "gross receipts" excludes all receipts other than those that are "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 purchaser within this state"⁹

The Guidance also revisits the FTB's prior, but withdrawn, position in Legal Division Guidance 2011-06-01 on the application of the R&D Credit to pure service companies. Changing course, the Guidance explains that taxpayers with no "gross receipts" for purposes of the R&D Credit (e.g., pure service companies or companies with only service receipts) may nevertheless claim the credit, although a reduced credit rate applies.¹⁰ Specifically, for taxable years 2000 and later, taxpayers with no "gross receipts" for purposes of the R&D Credit can take: (1) a credit equal to 7.5 percent of the qualified research expense (as defined) for the credit year; or (2) the reduced credit under IRC section 280C(c)(3).¹¹ The Guidance states that the FTB may publish additional guidelines on the mechanics of taking the R&D Credit.

While nevertheless helpful, one must keep in mind that Legal Division Guidance 2012-03-01 merely "represents informal advice" provided by the FTB "to external specialty publishers and non-legal staff in a form not generally reduced to formal written guidance," and that items published under Legal Division Guidance are not considered "written advice" that may be relied upon within the meaning of section 21012 and FTB Notice 2009-09.¹²

If you have any questions or would like further information on these developments, please contact: Eric J. Coffill, ECoffill@mofo.com, or Jenny Choi, JennyChoi@mofo.com, of Morrison & Foerster's Sacramento State & Local Tax Group.

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⁸ See FTB Legal Division Guidance 2012-03-01.

⁹ *Id.*

¹⁰ See *id.*

¹¹ IRC section 280C(c)(3) gives a taxpayer an election to take a reduced credit in exchange for the allowance of certain deductions. (See IRC § 280C(c).)

¹² See FTB's webpage on Legal Division Guidance, available at, www.ftb.ca.gov/law/Guidance/index.shtml.