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## The California Manufacturers' Investment Credit 'In-Lieu' Refund Provision--A New Twist

*Two taxpayers were able to use an R&D credit to reduce their income tax liability to the statutory minimum, thus forgoing use of the MIC in the same tax year, but they could elect the alternative in-lieu sales/use tax refund.*

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On 8/6/03, the California State Board of Equalization (SBE) decided 2-to-1 in favor of two Silicon Valley manufacturing companies, Cypress Semiconductor Corp. and LSI Logic Corp., regarding their claims for tax refunds under a seldom-used section of the California tax code relating to the state's manufacturers' investment credit (MIC). While this recent, taxpayer-favorable SBE ruling, discussed in more detail below, is certainly noteworthy, as this article went to press the California legislature has taken action, as also discussed below, to effectively preclude the decision's prospective application.

In the decision, the SBE voted to approve a refund, under Cal. Rev. & Tax. Code §6902.2, of a portion of the sales/use taxes the companies paid on their purchases of manufacturing and research equipment in California during the period in question. The refund was issued "in lieu" of the taxpayers' claiming an equivalent tax credit--the MIC--on their respective franchise tax returns. (That credit, if claimed, would have to be carried over because the taxpayers had applied the California research and development credit to reduce their current income/franchise tax liabilities to the statutory minimum.) The cases were combined as a convenience to the SBE because the issues in dispute were similar.

### **Overview**

As explained further, below, the manufacturers' investment credit may be claimed for income/franchise tax purposes in connection with the purchase of certain manufacturing equipment. In lieu of claiming the MIC, however, Cal. Rev. & Tax. Code §6902.2 provides that an equivalent refund may be claimed for a portion of the sales/use tax paid on the purchase of the MIC-qualified equipment. The taxpayer's sales tax refund may not exceed the MIC that could have been claimed to offset its income/franchise tax liability for a given year. Thus, a taxpayer still has to have an income/franchise tax liability in order to claim the sales tax refund, and most taxpayers historically have claimed the MIC, which is administratively a less-cumbersome process than applying for the refund under §6902.2.

So, why does this decision matter, and when would a company want to elect the in-lieu sales tax refund? For one thing, as explained below, for accounting purposes a sales tax refund is taken into consideration "above-the-line" (i.e., in pre-income-tax profit and loss). Furthermore,

if a manufacturing company engages in research and development (R&D) in California, and generates multiple credits (such as California's R&D credit under Cal. Rev. & Tax. Code §23609 and the MIC), the company may be able to optimize its benefits in a tax year by electing the sales tax refund option under §6902.2. As discussed further below, the two taxpayers involved in the current dispute were able to use the R&D credit to reduce their income/franchise tax liability to the statutory minimum, thus forgoing use of the MIC in the same tax year, but they could elect to claim the in-lieu sales/use tax refund.

This situation does not contemplate a taxpayer's generating a net operating loss for income/franchise tax purposes during a given tax year. In that circumstance, neither the MIC nor the "in-lieu" refund under §6902.2 provides a current-year benefit.

### **General Rules for the MIC**

Under Cal. Rev. & Tax. Code §23649, a corporation may claim a California franchise tax credit of 6% of the cost of qualified manufacturing or R&D property purchased or leased and placed in service in California during the year. To qualify for the credit, a company must be engaged in a line of business described in Standard Industrial Classification (SIC) Codes 2011 to 3999 (which is Division D, manufacturing), or 7371 to 7373 (software developers).<sup>1</sup> For purposes of the credit, a "line of business" generally is synonymous with an "establishment" as defined in the SIC Manual. An "establishment" is an economic unit, generally at a single physical location, where business is conducted or industrial operations are performed.

Many taxpayers have more than one establishment and thus may be classified under more than one SIC code. A taxpayer that has more than one establishment (i.e., is engaged in different lines of business) may claim the MIC only for qualified property used in a qualified line of business. Property used in a line of business not described in one of the specified SIC codes is not eligible for the credit.

To qualify for the MIC, the property must be either (1) tangible personal property described in IRC Section 1245(a) (generally, depreciable or amortizable property) that is used primarily (i.e., at least 50% of the time) in manufacturing or R&D; (2) certain special purpose buildings used by companies in specified high-tech businesses; (3) certain computer equipment or software; or (4) the value of certain capitalized labor costs that are directly allocable to the construction or modification of other qualified property. In addition, the property must be placed in service in California and the taxpayer must have paid California sales or use tax on the qualified property's cost, which must be properly chargeable to the taxpayer's capital asset account. Sales/use tax need not have been paid on the capitalized direct labor used in construction, installation, or repair of qualified property.

Property that is not eligible for the credit includes furniture, inventory, equipment used in storing or warehousing finished goods, and property used in administration, general management, or marketing. If property is not held for at least 12 months after being placed in service, any credit previously claimed is subject to recapture. Any credits in excess of the taxpayer's income/franchise tax liability for the year generally may be carried forward for up to eight years.

Certain leased property also may be eligible for the credit. In general, the sales or use tax must be paid in full on the initial acquisition of the leased property rather than deferred as sales/use tax paid on the lease stream or rental payments. The MIC is available to the lessee using the property, rather than to the lessor.<sup>2</sup>

## The In-Lieu Provision

Cal. Rev. & Tax. Code §6902.2, the "claim for refund in lieu of credit for tax for qualified property," states (in subsection (a)(1)): "In lieu of claiming the credit allowed by Section 17053.49 or 23649, a person who has paid sales tax reimbursement to a retailer or use tax on a purchase or purchases of property for which a credit may be allowed pursuant to those sections, may file a claim for refund equal to the credit amount that would otherwise be allowed pursuant to those sections." As noted above, the refund claimed may not be greater than the credit that could have been used to offset the corporation's franchise tax.

In addition, §6902.2(a)(1) provides that the claim for refund "shall be filed no earlier than the date a claim could have been made for a tax credit or carryover of a credit under Section ... 23649" (the MIC), thus preventing taxpayers from otherwise accelerating the MIC by electing the in-lieu provision. This provision also effectively extends the statute of limitations for claiming the refund under the "in lieu" provision to four years (the income/franchise tax limitations statute), rather than the three-year statute for sales and use tax refund claims.

Under the California Franchise Tax Board's MIC regulations, 18 Cal. Code Regs. §23649-11(c) refers to the in-lieu sales tax refund election under Cal. Rev. & Tax. Code §6902.2, and notes that such refunds may be claimed only "at the times and in the amounts that the MIC *could have been actually used* by the qualified taxpayer to offset its California franchise or income tax liability for the income year or years in which the refund claim is filed." (Emphasis added.) In addition, the election to use Cal. Rev. & Tax. Code §6902.2 "shall apply to each specific item of qualified property and shall also include any capitalized labor costs that are directly allocable to such item of qualified property."

Also, §6902.2(a)(3) requires that a taxpayer that claims the in-lieu sales/use tax refund must make "an irrevocable election to waive the equivalent amount of [manufacturers' investment] credit" on those same assets. A request for the in-lieu sales/use tax refund generally must be accompanied by proof of payment of the tax to a retailer (or payment of use tax). Such proof should include an invoice or purchase order that contains the following information: (1) the date of purchase, (2) a description of the property purchased, (3) the purchase price of the property, and (4) the amount of sales tax paid in connection with the purchase.

Cal. Rev. & Tax. Code §6902.2 originally was included in the law to permit taxpayers to claim the MIC as an "above-the-line" item for accounting purposes so that the benefit could be tracked by companies at the operating divisional level. (That is, as a sales tax refund, rather than an income/franchise tax credit, the benefit is taken into account in computing profit and loss before income taxes, and also could more easily be assigned to a particular division or unit within the company.) For years, the in-lieu provision has been largely unused because, as noted above, taxpayers still had to show a franchise/income tax liability before claiming credits in order to claim either the MIC or the in-lieu sales tax refund, and because requesting a sales or use tax refund generally is more cumbersome than a claim for the MIC (because, for the sales/use tax refund, supporting documentation often has to be provided earlier and in more complete form). Thus, historically, very few claims for refund under §6902.2 were filed.

Also significant is that, unlike many other states, California does not have a blanket manufacturer's exemption from sales and use tax. The enactment (in the mid-1990s) of the MIC, the related manufacturer's sales tax exemption for new businesses (Cal. Rev. & Tax. Code §6377), and the in-lieu sales/use tax refund provision was a compromise to afford California manufacturers some benefits for investing in manufacturing machinery and equipment in the state. Nevertheless, both the MIC and the in-lieu refund represent only partial relief from the combined state and local sales and use taxes imposed by California's various taxing jurisdictions.

### **How the In-Lieu Refund Can Benefit a Taxpayer**

In summary, based on the SBE's 8/6/03 decision, if a taxpayer has an income/franchise tax liability before credits, and has generated a MIC in an open tax year, the company may either (1) claim the MIC against its income/franchise tax under Cal. Rev. & Tax. Code §23649, or (2) elect under Cal. Rev. & Tax. Code §6902.2 to apply for a sales and use tax refund equal to the MIC that could have been claimed. A taxpayer likely would choose the latter alternative if it has generated other credits, such as the R&D credit, on the same income/franchise tax return. By choosing the refund under §6902.2, the taxpayer is able to effectively maximize the use of both credits.

**Example.** The taxpayer, TechCo, Inc., reports a California income/franchise tax liability of \$100,000, before credits, on line 24 of its California Form 100. In addition, TechCo generates a MIC of \$250,000 and an R&D credit of \$500,000. By itself, the MIC could be used to offset \$99,200 of the income/franchise tax liability (California imposes an \$800 minimum tax that may not be offset by these credits). In the alternative, the taxpayer could elect to claim an in-lieu sales and use tax refund to the extent of the forgone MIC, i.e., \$99,200.

When TechCo files its Form 100 for the tax year, the taxpayer uses \$99,200 of its R&D credit to offset its entire tax liability except for the minimum tax. The taxpayer can then also make an irrevocable election to waive that portion of its MIC and request from the SBE a \$99,200 in-lieu sales and use tax refund under Cal. Rev. & Tax. Code §6902.2. Under existing California law, TechCo should receive a partial refund of the sales or use taxes it paid on the purchase of manufacturing assets placed in service in California, and also will be entitled to claim the R&D credit on its franchise tax return.

### **What the Future Holds**

As of this writing, the only SBE decision on this issue has been in the combined case regarding Cypress Semiconductor Corp. and LSI Logic Corp. Despite the favorable outcome for these companies for the years in question, other taxpayers with pending refund claims must wait for their own "day in court" and may not rely on the decision in this case. Since the decision was rendered by only three SBE members (the other two members recused themselves), another case on the same issue likely will be heard in upcoming months.

The main driver behind the SBE's supporting the taxpayers' interpretation of the "in-lieu" provision in this case appears to be a desire to encourage businesses to locate and expand their manufacturing operations in California. During the hearing, SBE member Bill Leonard commented on the policy implications of this case, remarking that the purpose of the R&D credit and the MIC was to promote both increased research and increased manufacturing activities in the state. By denying the in-lieu refund claim in this case, the SBE would have been sending a message that taxpayers may receive current tax benefits for investing in only one of those activities in California.

**Legislative activity.** As of this writing, however, the "message" is that the legislature has passed and sent to Governor Davis, for his expected signature, S.B. 1064, which removes the "in-lieu" benefit as applied in the decision discussed above for claims filed with the SBE after 8/6/03, the date of that decision. Basically, the legislation amends Cal. Rev. & Tax. Code §6902.2 to limit the in-lieu sales/use tax refund to the taxpayer's current tax liability after any credits.

Furthermore, under the MIC statute's annual employment test, total employment in California's manufacturing sector did not meet the required minimum. Thus the standard MIC under Cal. Rev. & Tax. Code §23649 is scheduled to sunset on 12/31/03 and, as a result, assets placed in service after that date will not qualify for the credit.

Currently, several interested groups are encouraging California legislators to rethink the sunset and extend the credit. In exchange, under some proposals taxpayers may have to accept additional reporting requirements or certain limitations. Many business groups will be anxious to discuss an extension of the MIC in any special legislative session convening after the October 7 gubernatorial recall election, or when the legislature reconvenes in January 2004. Perhaps this case will serve to illustrate that action should be taken to continue to encourage companies to invest in California, and that the MIC and related credits should continue to be a part of the state's tax landscape.

**Practice Note: Maximizing Benefits**

Why does the California State Board of Equalization's 8/6/03 decision in favor of Cypress Semiconductor Corp. and LSI Logic Corp. matter? First of all, it will matter in the future only if the legislature reverses S.B. 1064, which precludes the decision's prospective application. If that occurs, then consider, for example, a California manufacturer that also engages in research and development, and thereby generates both the California R&D credit and the state's manufacturers' investment credit (MIC). The use of the R&D credit may sufficiently reduce the tax liability so as to preclude use of the MIC. Nevertheless, the company may be able to optimize its benefits by electing the sales tax refund option under Cal. Rev. & Tax. Code §6902.2 in lieu of the MIC.

**Notes**

<sup>1</sup> As published in the federal *Standard Industrial Classification Manual* (U.S. Office of Management and Budget, 1987).

<sup>2</sup> Similar provisions under Cal. Rev. & Tax. Code §17053.49 make the manufacturers' investment credit (MIC) available for purposes of the California personal income tax. For a more detailed discussion of the MIC, see Danowitz, Leombruno, and Farrell, "California Manufacturers' Investment Credit Regs. Seem to Narrow the Statute's Scope," 6 JMT 82 (May/June 1996). See also Micheli, "How Much Do California's Manufacturing Tax Incentives Cost?--A Look at Taxpayer Usage," 11 JMT 24 (Mar/Apr 2001).