

## California Limits Tax Credit Utilization, But Allows Assignment to Unitary Affiliates

Michael J. Cataldo

By enactment of Assembly Bill 1452, tax credits of corporate and personal income taxpayers are limited to 50 percent of the tax for taxable years beginning in 2008 and 2009, and, for taxable years beginning on or after July 1, 2008, corporate taxpayers may assign credits to unitary affiliates, which may utilize the assigned credits beginning in 2010.

### Limitation of Credit Utilization

Assembly Bill (“AB”) 1452 limits the amount of credits that may be used to offset the tax. Under both the Corporation Tax Law (“CTL”) and the Personal Income Tax Law (“PITL”), for taxable years beginning on or after January 1, 2008, and before January 1, 2010, the total of all credits (including carryovers of any credit) may not be used to reduce the tax below 50 percent of the tax prior to application of the credits.<sup>1</sup> The credit carryover period is increased for each year a credit is disallowed by this limitation.<sup>2</sup>

AB 1452 provides that corporate taxpayers with less than \$500,000 of taxable income subject to California tax for the taxable year, and taxpayers subject to the PITL with net business income of less than \$500,000 for the taxable year are exempt from the credit utilization limitation.<sup>3</sup> The \$500,000 income limit for taxpayers subject to the corporate tax is based on the taxpayer’s

California source income.<sup>4</sup> For purposes of the PITL, “business income” means income from a trade or business, whether conducted directly by the taxpayer, or by a pass-through entity owned directly or indirectly by the taxpayer, income from rental activity, and income attributable to a farming business.<sup>5</sup> A pass-through entity is defined as a partnership or S corporation for these purposes.<sup>6</sup>

### Assignment of Credits

AB 1452 also reduces the restrictions on the utilization of tax credits earned by taxpayer members of a combined reporting group.<sup>7</sup> For taxable years beginning on or after July 1, 2008, corporate taxpayers may elect to assign certain “eligible credits” to “eligible assignees.”<sup>8</sup> The election is irrevocable, and must be made on the assigning taxpayer’s original return for the year of the credit assignment.<sup>9</sup>

An “eligible credit” is a credit earned by the taxpayer, or eligible to be carried forward by the taxpayer to a taxable year beginning on or after July 1, 2008.<sup>10</sup> An

<sup>1</sup> Sections 17039.2 and 23036.2. All statutory references are to the California Revenue and Taxation Code. Certain personal income tax credits (e.g., household and dependent care credit, personal exemption credit) are exempt from these credit utilization limitations under the PITL. These personal tax credits must be applied against the tax before any credits that are subject to the utilization limitation are applied.

<sup>2</sup> Sections 17039.2(e) and 23036.2(d).

<sup>3</sup> Sections 17039.2(g) and 23036.2(e).

<sup>4</sup> See *FTB Tax News*, January 2009, and FTB Form 100 Instructions, *What’s New/Tax Law Changes*. The author has confirmed in an informal discussion with FTB legal counsel that the \$500,000 threshold is considered on a post-apportioned basis, and that the amount reported on line 19 of Form 100 must be less than \$500,000 for the exemption from the credit utilization limitation to apply.

<sup>5</sup> Section 17039.2(g).

<sup>6</sup> Section 17039.2(g)(1).

<sup>7</sup> In *General Motors v. Franchise Tax Board*, 39 Cal.4th 773 (2006), the California Supreme Court held that tax credits are not apportioned among members of a combined reporting group, but rather may only offset the tax of the individual corporate members of the group that engaged in the activities generating the credit. The Supreme Court did not address whether taxpayers may obtain equitable relief pursuant to Section 25137 to reallocate credits to taxpayer members that have sufficient tax liability to use the credits.

<sup>8</sup> Section 23663(a)(1).

<sup>9</sup> Section 23663(c)(1).

<sup>10</sup> Section 23663(b)(2). The credit must be authorized under Chapter 3.5, thus the Alternative Minimum Tax Credit is not an “eligible credit.” See Section 23663(a)(1).

*Michael J. Cataldo is a tax associate in the San Francisco office of Pillsbury Winthrop Shaw Pittman LLP. This article can also be found as part of the Pillsbury Winthrop Shaw Pittman LLP Tax Page. See Important Notice to Readers.*

“eligible assignee” is a member of the same combined reporting group of the taxpayer assigning the credit as of a specified date.<sup>11</sup> Taxpayers may assign credits earned in taxable years beginning on or after July 1, 2008, if the assignee is included in the same combined reporting group as the assignor on the last day of the first taxable year in which the credit was allowed, and the last day of the assigning taxpayer’s taxable year the credit is assigned.<sup>12</sup> Taxpayers may assign a credit carry forward if the assignee and assignor are included in the same combined reporting group as of June 30, 2008, and on the last day of the assigning taxpayer’s taxable year the credit is assigned.<sup>13</sup>

Credits may only be applied by the assignee against its tax in taxable years beginning on or after January 1, 2010.<sup>14</sup> The assigning taxpayer must reduce the amount of its credits and credit carryovers available to apply against its own tax by the amount of credit it assigns.<sup>15</sup> Once the credit is assigned, the assignee is treated as if it originally earned the assigned credit, and may not re-assign or otherwise transfer the assigned credits.<sup>16</sup> The assignee may apply all or any portion of the assigned credits against its own tax for the taxable year the assignment occurs, and to subsequent taxable years subject to any carryover period limitations.<sup>17</sup>

Consideration may, but is not required to, be paid by the assignee to the assignor.<sup>18</sup> If consideration is paid, no deduction is permitted for the payment of such consideration, nor is the recipient required to include the consideration in gross income for California purposes.<sup>19</sup>

<sup>11</sup> Section 23663(b)(3).

<sup>12</sup> Section 23663(b)(3)(B).

<sup>13</sup> Section 23663(b)(3)(A).

<sup>14</sup> Section 23663(a)(2).

<sup>15</sup> Section 23663(c)(2).

<sup>16</sup> Sections 23663(a)(3) and 23663(c)(3), (4).

<sup>17</sup> Section 23663(c)(3).

<sup>18</sup> Section 23663(d)(1).

<sup>19</sup> Section 23663(d)(2). Query whether a deduction would be permitted or inclusion in gross income required for federal income tax purposes due to the assignment of California tax credits, with or without consideration.

## Frequently Asked Questions on Assignment of Credits

The Franchise Tax Board (“FTB”) released a set of Frequently Asked Questions (“FAQs”) and Form 3544 concerning the new credit assignment provisions. On April 3, 2009, FTB held an interested parties meeting (“IPM”) to discuss the FAQs, and recently released a summary of the IPM (“FTB Summary of IPM”). FTB addressed the manner in which the credit assignment election must be made, substantiation of the credit after assignment, and post-assignment credit utilization limitations.

### *Making the Election - Form 3544*

The FAQs state that taxpayers who assign credits must file Form 3544 with their original return for the taxable year of the assignment, and must file a separate form for each type of credit assigned.<sup>20</sup> Thus, if a taxpayer is assigning two different credits to the same assignee, it must attach two separate forms to its original return.<sup>21</sup> The assigned credits must be itemized by the taxable year they were generated, the amount available for assignment, the amount assigned, and the balance of the credit available to the assignor after assignment.<sup>22</sup> Form 3544 is only required to be filed for the year of assignment, not annually, to report the status of assigned credits.<sup>23</sup>

At the IPM, FTB staff stated that since the election to assign credit is irrevocable, it must be made on the first return filed for the tax year. Thus, if a second return for the tax year is filed before the original due date, that return will not be considered an “original return” for purposes of electing to assign credit. This is in contrast to the federal rule otherwise followed by California which defines an “original return” to include any return (even an amended return) filed before the original due date. FTB staff stated that the election cannot be made on a second return, even if that return is an “original” return because allowing such an assignment on a second return would be inconsistent with the irrevocable nature of the

<sup>20</sup> FAQ Number 8.

<sup>21</sup> FAQ Number 6 and Instruction to Form 3544.

<sup>22</sup> Instructions to Form 3544.

<sup>23</sup> FAQ Number 8.

assignment.<sup>24</sup> Several parties in attendance requested FTB reexamine this position because otherwise the definition of “original return” would be different for purposes of the credit assignment statute than for all other sections of the California Revenue and Taxation Code. FTB staff agreed to reexamine this position.

#### *Credit Substantiation*

If a corporation leaves the combined reporting group after being assigned credits, the departing corporation takes the credits (and limitations) with it, and must be able to substantiate the assigned credit in post-affiliation years.<sup>25</sup> If FTB decides on audit that an assignee and assignor were not unitary at the time of assignment, the assignment will be disallowed and the assigned credit will return to the assignor for future use provided the statute of limitations remains open.<sup>26</sup>

The assignor must maintain the information necessary to substantiate any credit assigned and to verify the assignment and subsequent use of the credit assigned. Lack of substantiation may result in the disallowance of the assignment.<sup>27</sup> An assignee that subsequently leaves the combined reporting group must be able to substantiate the credits with supporting documentation.<sup>28</sup> The assignor and assignee are jointly and severally liable for any tax, penalty and interest resulting from the disallowance of any amount of assigned credit.<sup>29</sup> FTB may disallow the assigned credit under audit of either the assignor or assignee, and will determine the ordering of any such credit disallowance on a case-by-case basis, depending on the facts and circumstances.<sup>30</sup>

#### *Credit Limitations*

The FAQs and Instructions to Form 3544 state that the same credit limitations that would have been imposed upon the assignor before the assignment of the credit

will be imposed upon the assignee, including carryover periods, Internal Revenue Code section 383 limitations (as modified by Section 24481), and Enterprise Zone (“EZ”) income requirements.<sup>31</sup> For purposes of EZ credit limitations, the assignee may only utilize the credit to the extent it has income from the specific EZ where the assignor generated the credit.<sup>32</sup> However, only the assignor is required to add back the wage deduction to taxable income for wages upon which the EZ credit is based, in the year the credit is earned.<sup>33</sup>

#### *Future Guidance*

FTB acknowledged that several issues are not addressed in the FAQs, and stated that it would analyze the issues and supplement the FAQs at a later date. The issues identified in the FTB Summary of the IPM include whether a taxpayer may assign a specific portion of a credit, for example EZ credits related solely to targeted employment area employees, Manufacturers Investment Credit relating only to a specific asset, or Research and Development (“R&D”) Credit relating only to a specific project. FTB will also address whether an entity assigned R&D Credit must itself be engaged in qualified research in order to use the assigned credit.

#### **Important Notice to Readers**

**T**his material is not intended to constitute a complete analysis of all tax considerations. Internal Revenue Service regulations generally provide that, for the purpose of avoiding United States federal tax penalties, a taxpayer may rely only on formal written opinions meeting specific regulatory requirements. This material does not meet those requirements. Accordingly, this material was not intended or written to be used, and a taxpayer cannot use it, for the purpose of avoiding United States federal or other tax penalties or of promoting, marketing or recommending to another party any tax-related matters.

<sup>24</sup> FTB Summary of IPM, FAQ Number 7.

<sup>25</sup> FAQ Number 12.

<sup>26</sup> FAQ Number 13.

<sup>27</sup> Instructions to Form 3544.

<sup>28</sup> FAQ Number 16.

<sup>29</sup> Section 23663(f)(1).

<sup>30</sup> FTB Summary of IPM, addressing FAQ Number 12.

<sup>31</sup> FAQ Number 17.

<sup>32</sup> Instructions to Form 3544.

<sup>33</sup> FTB Summary of IPM, addressing FAQ Number 20.