CHAPTER 2C

CORPORATION TAX

HIGHLIGHTS

• Minimum Tax	$800 per year; except for new corporations.	
• Revenue*	2004-05	$8.7 billion
	2005-06 (estimate)	$9.6 billion
	2006-07 (estimate)	$10.0 billion
• Estimated Number of Returns Filed	637,000 in 2004	
• Administration	Franchise Tax Board (FTB)	

*Source: Governor's 2006-07 Budget Summary

1. WHO PAYS THE CORPORATION TAX

The **corporation tax** applies to all corporations that earn income derived from or attributable to sources in California, except insurance companies. Professional corporations, associations, certain trusts, partnerships and limited liability company(s) (LLCs) electing to be taxed as corporations, banks, and financial institutions such as savings and loan associations (thrifts) pay taxes under the Corporation Tax Law.

Nonprofit organizations are exempt from the corporation tax, except for income that is unrelated to their exempt purpose (see Section 13 of this chapter).

Insurance companies are exempted from the corporation tax (and most other state and local taxes) pursuant to the state Constitution. Instead, insurance companies are subject to a state gross premiums tax. (See Chapter 3C of this Reference Book for more information on the Insurance Gross Premiums Tax.)

Additional discussion about which corporations are subject to the corporation tax is provided in Section 3 below, entitled "Three Separate Taxes Comprise the Corporation Tax."

2. CALCULATION OF THE CORPORATION TAX

Taxpayers compute their tax liabilities based on income earned during the year. The year may be either a calendar year, or a fiscal year commencing in any month except January as specified by the taxpayer.

A brief summary of how tax is computed is as follows: Taxpayers must add up all sources of non-exempt income and subtract total deductions to which they are entitled, thereby arriving at "net income". They then apply the 8.84% tax rate to net income to determine the tax. Certain tax credits are allowed to reduce this tax, dollar for dollar. Also, corporate taxpayers may be liable for the alternative minimum tax.

The California corporation tax is similar, but not identical to, the federal income tax on corporations. Major differences are identified below.

When corporations do business both within and outside of California, it is necessary to determine what portion of total corporate income is taxable by California. This is done by means of formula apportionment, which is described in Chapter 2D, entitled "Determining the Income of Multistate and Multinational Corporations".

Refer to Chapter 2B on the Personal Income Tax for further information on taxes imposed on unincorporated businesses.

3. THREE SEPARATE TAXES COMPRISE THE CORPORATION TAX

There are three separate taxes levied under the umbrella of the state corporation tax:

- Corporation Franchise Tax. Every corporation doing business in California (regardless of location) is subject to the franchise tax. "Doing business" means "actively engaging in any transaction for the purpose of financial or pecuniary gain or profit".

  The franchise tax is not a tax on income. Rather, it is a tax for the privilege of doing business in California measured by net income earned in California. Until changed by the Legislature in AB 1843 (Ackerman), Chapter 862, Statutes of 2000, a corporation paid the privilege tax for conducting business in the current year based upon (measured by) the corporation's income in the preceding year. As amended, the law requires a corporation to pay tax for the privilege of conducting business in this state for the current year based upon (measured by) the corporations' net income for the current year.

  The majority of corporations taxed by California pay the franchise tax.

- Corporation Income Tax. Corporations deriving income from California sources but not sufficiently present to be classified as "doing business" in California are subject to the corporation income tax.

  This tax is nearly identical to the franchise tax. Because it is an income tax, however, interest from tax-exempt United States, California, or California municipality obligations is not included in incomes. Also, corporations are not subject to the minimum franchise tax.

  The most common situation where the corporation income tax is applied

rather than the franchise tax is where a corporation operates in California through an agent or by using traveling salespersons, so the corporation does not have an established presence in the state. Another business entity commonly subject to the corporation income tax is a "business trust", which is a trust established for the purpose of making a profit (rather than for mere conservation of assets).

Very few corporate taxpayers file under the corporation income tax.

° Bank Tax. Banks and financial institutions doing business in California are subject to an additional tax (known as the bank tax), which is levied in conjunction with the regular corporation tax. This tax is in lieu of personal property taxes and local business taxes, from which banks and financial institutions have been exempt since the enactment of the corporation tax in the 1930s.

The bank tax rate is 2% and is designed to be equivalent to the average amount general corporations pay each year in personal property taxes and local business taxes (see below for a further discussion).

Federal law has a net income tax which applies to all corporate taxpayers, and does not have an add-on bank tax rate.

4. TAX RATES AND MINIMUM FRANCHISE TAX

The corporation franchise tax rate is the greater of 8.84% of net income, or the minimum franchise tax.

The minimum franchise tax is $800 and must be paid by any corporation subject to the franchise tax with a computed tax liability less than this amount. The $800 minimum franchise tax is not imposed for the first year a corporation is in existence. This corporation would, however, be subject to the 8.84% franchise tax rate on any net income.

The corporation income tax rate is also 8.84% of net income. However, the minimum franchise tax does not apply.

The bank tax rate, which must be added to the franchise tax rate for banks and financial institutions, is statutorily set at 2%. Banks are subject to the minimum franchise tax if their computed tax from the combined corporate plus bank rates is less than $800. Federal corporate tax rates range from a low of 15% to a high of 38%. There is no minimum tax in federal law comparable to the state's minimum franchise tax.

5. INCOME AND DEDUCTIONS

Corporations begin computing their California tax by adding all sources of income, including income from business activities, dividends, interest, rents, royalties, gains from

the sale of property, income from the discharge of debt, and so on. Unlike federal law, interest from federal, state and municipal obligations are included in total income under California franchise tax. For corporations, there are few exclusions from income or sources of exempt income unlike those in the personal income tax.

The corporate tax is measured not by gross income, but by net income, which is what we commonly think of as business profit. In order to determine net income, corporations are allowed to deduct specified expenses from gross income.

The value of a deduction to a taxpayer, measured in terms of tax eliminated, generally may be estimated by multiplying the deduction by the tax rate. Therefore, the state tax savings to a corporation resulting from deducting a $1,000 expense is $88.40 ($1,000 expense x 8.84% state corporate tax rate).

The most important deductions available to corporations are described below. Unless noted otherwise, these are generally similar to deductions allowed to corporations in federal law.

- Trade or Business Expenses. Taxpayers are permitted to deduct the ordinary and necessary expenses of conducting a trade or business. Typical deductible expenses include compensation and fringe benefits for employees, the employer's portions of unemployment insurance and social security taxes, rent, utilities, advertising, and other similar current costs. Capital expenditures (that is, those that add to the value or useful life of property) cannot be deducted. Rather, they must be depreciated. (See Section 6 below.)

- Taxes. Corporations may deduct real and personal property taxes. Local, state, federal, and foreign income or profits taxes are not deductible. Sales taxes are also generally deductible; however, sales taxes incurred in the process of manufacturing or constructing property must be capitalized into the value of the property.

- Interest. In general, corporations may deduct all interest paid or accrued on business debts. While generally in conformity with federal law, California applies special rules to determine the interest expense of multistate and international corporations.

- Meals, Travel, Entertainment, and Private Club Expenses. Meal, travel, and entertainment costs are 50% deductible. Certain convention and cruise ship expenses are subject to special limitations. California conforms to the federal denial of club dues deduction.

- Charitable Contributions. Corporations may deduct the value of contributions to charitable or nonprofit organization. The maximum deduction is 10% of net income; excess contributions may be carried over to the next five succeeding taxable years. Deductions for contributions of appreciated

property (property that has increased in value) generally are limited to the basis (cost) of the property.

Various other more specialized deductions are available to corporations. Some of these deductions are described below.

6. DIVIDENDS RECEIVED DEDUCTION

Under present law, dividends received from general corporations may be eliminated if the corporation is a member of the taxpayers combined filing group.

Prior California law allowed corporate taxpayers a dividend received deduction (DRD) for dividends received from corporations that were not part of the taxpayer's filing group. The purpose of the DRD was to avoid double taxation by California on income reported at the corporate level. The payor of the dividend had to pay California tax on the income from which the dividend was paid. Without DRD relief, the corporation receiving the dividend included the dividend in income.

The DRD was computed as a percentage of the dividends received; the percentage varied depending upon the taxpayer's ownership interest in the payor corporation and whether the income of the payor corporation was subject to California income or franchise tax. The DRD was authorized for payments made by general corporations in Revenue and Taxation Code (R&TC) Section 24402; the DRD was authorized for payments made by an insurance corporation in R&TC Section 24410.

The courts declared R&TC Sections 24402 and 24410 discriminatory against non-Californian businesses and, therefore, unconstitutional. [See Farmer Bros. Co. v. Franchise Tax Board (2003) 108 Cal.App. 4th 976, cert. denied 540 U.S. 1178, and Ceridian Corp. v. Franchise Tax Board (2000) 85 Cal.App. 4th 875 (modified 86 Cal.App. 4th 483).] The FTB, with concurrence from Legislative Counsel, holds that for taxable years beginning after December 1999, neither code section provides a DRD.

In 2004, the Legislature responded to the Ceridian decision with AB 263 (Oropeza), Chapter 868, Statutes of 2004. For taxable years beginning on or after January 1, 2004, corporations are allowed an 80% DRD (85% beginning in 2009) for dividends received from 80% or greater owned insurance companies. If the insurance company is overcapitalized (stuffed), the 80% DRD is phased out based on a "premiums received to total income earned" ratio. For years beginning before January 1, 2004, the taxpayer may elect by March 28, 2004, to have the 80% DRD and phase out ratio apply. If a proper election is made, for taxable years beginning before 2004, the taxpayer may deduct expenses associated with earning the dividend income. AB 263 also contains other provisions addressing transactions between general corporations and insurance companies.

No legislation has been enacted that amends R&TC Section 24402, which previously allowed a DRD for dividends received from general corporations.

7. DEPRECIATION AND AMORTIZATION

Depreciation and amortization deductions allow taxpayers to recover capital investments in assets over the useful lives of those assets by deducting reasonable allowances for the exhaustion or wear and tear of the property. The idea behind depreciation is that capital assets are used over several years. For that reason, their cost of acquisition should be deducted over several years rather than all at once in the year in which the asset is purchased.

Depreciation and amortization are allowed for property, other than land, used in a trade or business or for the production of income (investment), including most kinds of tangible property and improvements to real property, farm buildings, machinery and other physical assets. Intangible assets that may be amortized include copyrights, licenses, franchises, goodwill, and covenants not to compete. Depreciation is not allowed for property used for personal purposes, inventory and stock in trade, land, and depletable natural resources. (See Section 7 on Depletion below.)

For corporation tax purposes, California generally does not allow use of the federal depreciation system called the Modified Accelerated Cost Recovery System, or MACRS. Instead, California uses a depreciation system generally known as the Asset Depreciation Range (ADR) system, which is similar to that used in federal law for pre-1981 assets. The ADR system generally requires the use of longer useful lives and fewer accelerated depreciation methods than would be allowed under the federal MACRS system.

Under the ADR system, assets are generally depreciated over the remaining useful life of the asset or over a designated "class life". Under this system, assets are grouped into more than 100 classes, and a guideline "life" for each class is established. For purposes of the ADR system, taxpayers may use a straight-line depreciation or certain rapid depreciation methods (such as double declining-balance, 150% declining balance, sum-of-the-years-digits, or other consistent methods). The amount that is to be depreciated is the property's basis, which is typically its value when acquired. Any depreciation that would be greater than that computed under the straight-line method is considered excess depreciation and is subject to the alternative minimum tax.

Effective for taxable years beginning on or after January 1, 2005 [AB 115 (Klehs), Chapter 691, Statutes of 2005], the Corporate Tax Law conforms to the Internal Revenue Code (IRC) Section 179 expensing provisions to the same extent under the Personal Income Tax Law. That is, a corporate taxpayer with a sufficiently small amount of annual investment would be able to elect to deduct up to $25,000 of the cost of qualifying property placed in service for the taxable year in lieu of the current law "additional first-year depreciation" of up to $2,000. The $25,000 amount would be reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000. Prior to AB 115, only S corporations (see Section 10 of this Chapter) were permitted a IRC Section 179 deduction under the California Tax Law.

State law allows taxpayers doing business in certain economic incentive areas such as enterprise zones (EZs), local agency military base recovery areas (LAMBRAs), and targeted tax areas (TTAs) to treat the cost of qualified property as an expense in the year the property is placed in service in the area.

8. DEPLETION

California closely conforms to federal law in the area of depletion deductions. Depletion deductions allow owners of natural resources to recover the costs of the resource as it is extracted, harvested, or otherwise diminished. Depletion is to the owner of an oil or gas well or mineral or timber property what depreciation is to the owner of a capital asset.

Depletion deductions are allowed to any taxpayer with an economic interest in a property containing depletable resources. Two alternative depletion computations are provided in both state and federal law. The taxpayer must compute the depletion amount both ways and may deduct the larger amount. The two methods are:

- Cost Depletion. Cost depletion requires the taxpayer to estimate the yield of the resource (e.g., 10 million barrels of oil). Then, the cost associated with extracting the resource is divided by the number of units. The resulting quotient is the cost depletion per unit. That amount multiplied by the number of units extracted and sold during the year determines the cost depletion that is deductible for the year. Each year, the cost basis of the property is reduced by the amount of depletion deducted for that year until the entire cost basis has been deducted. At that point, no additional cost depletion is allowed.

- Percentage Depletion. Most depletable property qualifies for this alternate computation method. However, it is not available for timber. Under percentage depletion, a flat statutorily set percentage of annual gross income from the natural resource property is taken as the depletion deduction each year. Thus, the deduction bears no relationship to the actual amount of the resource extracted during the year. However, the laws set an upper limit on the deduction of 50% of the taxable income from the property (100% for oil and gas properties).

9. CARRYOVER OF NET OPERATING LOSSES

Businesses incur "net operating losses" (NOLs) for tax purposes when allowable deductions exceed gross income. When deductions are less than gross income, the business has net income (i.e., shows a profit). A business may show a net operating loss for tax purposes without incurring actual out-of-pocket losses, due to the allowance of tax deductions for items that may not be actual out-of-pocket expenses, such as carryforward of deductions from prior years and depreciation.
In a year when a business shows a net operating loss for tax purposes, the business is not required to pay any corporation taxes beyond the minimum franchise tax.

Similar to federal law, California law allows businesses with NOLs to carry over a portion of these losses and deduct them against income earned in future years. Note: California imposes considerably more restrictions on the ability to use NOLs – see discussion below. NOL carryover rules apply to trade or business losses only, not personal losses. Identical NOL carryover rules apply in both the Corporation Tax Law and the Personal Income Tax Law.

Under federal law, 100% of a business's NOL can be carried back for two years and carried forward for twenty years. California limits the amount of NOL deductions that can be carried forward and does not allow NOL deductions to be carried back. For taxable years beginning before January 1, 2000, California allowed 50% of NOLs to be carried forward for five years. The carryforward period and carryforward amounts have been adjusted as follows:

Tax Year	Allowed Carryforward	Length of Carryforward
1999 and earlier	50%	5 years
2000, 2001	55%	10 years
2002, 2003	60%	10 years
2004 and after	100%	10 years

In 2002, as part of the budget package, California suspended taxpayers' ability to claim NOL deductions during the 2002 and 2003 tax years. To mitigate the impact of the NOL suspension, taxpayers that accrued NOLs prior to January 1, 2002 were given two additional years during which to claim these NOLs, and taxpayers that accrued NOLs during the 2002 calendar year were given one additional year in which to claim them.

Prior to the changes made in 2002, special NOL carryforward rules were available to specific groups of taxpayers, as shown below. After the 2002 legislation changes, virtually all businesses are treated the same way under California's NOL laws. Pre-2002 tax treatment of NOLs is summarized below in order to provide an historical context.

Categories of taxpayers who were previously provided special NOL treatment are as follows:

- New businesses that incurred a NOL in any of their first three years of operation were allowed a 100% carryover. For the purpose of NOL carryforward, a new business was defined as any trade or business activity that is first commenced in California on or after January 1, 1994. A new business did not include any trade or business that was used in any predecessor trade or business conducted by either the taxpayer or a related taxpayer. For taxable years beginning before January 1, 2000, a new business that incurred a loss in its first year was allowed to carry forward 100% of that loss for up to eight-years; losses incurred in the second year of the same business could be carried forward for up to seven years; and losses incurred in the third year of the same business could be carried forward for up to six

years. For taxable years beginning on or after January 1, 2000, new businesses were permitted to carry forward 100% of the NOLs they incurred during each of their first three years of operation for ten years.

- Eligible small business taxpayers were allowed a 100% carryover for NOLs incurred in taxable years beginning on or after January 1, 1994. Small business taxpayers were those who have gross receipts, less returns and allowances, of less than $1 million during the year of the loss.

- Taxpayers in Enterprise Zones, Local Agency Military Base Recovery Areas, and Targeted Tax Areas were and still are allowed to carry over 100% of the NOL for 15 years. These NOLs may reduce income earned within the designated area only, and may not be used as a deduction against income earned outside the area.

10. TREATMENT OF S CORPORATIONS

"S corporations" are named for a subchapter of federal income tax laws (United States Code, Title 26, Subchapter S) that grant certain corporations special tax treatment.

As defined by federal law, S Corporations are domestic corporations with 100 or fewer shareholders, only one class of stock, no shareholders other than individuals, estates, trusts, and certain exempt organizations, and not a member of an affiliated group. In general, S corporations must be involved in an active trade or business and are limited with respect to the amount of passive investment income from royalties, dividends, and interest they may receive. Corporations that meet these definitions may elect to be exempt from the federal corporate tax, and instead pass through the corporation's taxable income to its individual shareholders.

A corporation's California tax status must be the same as its federal tax status is. That is, a corporation that elects to be taxed as an S Corporation for federal purposes must be taxed as an S Corporation for California tax purposes. Similarly, a corporation cannot be an S Corporation for California tax purposes unless it has a valid federal S election in place.

Once a business elects S Corporation status, its corporate income is taxed at a rate of 1.5% instead of the normal 8.84%, and credits are limited to one-third of the C Corporation credit amounts. One hundred percent of the corporation's items of income, loss, deduction and credits are passed through to the shareholder in accordance with their respective interests in the corporation.

Federal and state laws permit S Corporations to own 100% of another domestic corporation and to make an election to treat the owned corporation as a Qualified Subchapter S Subsidiary (QSub). All of the activities, assets, liabilities, income, deductions and losses of the QSub are treated as the activities, assets, liabilities, income, deductions and losses of the parent S Corporation. The parent S Corporation pays tax on the entire amount of income reported and passes the full amount through to its

shareholders. California law imposes a tax equal to the minimum franchise tax to the QSub.

Under California law, S Corporations are permitted to use the MACRS depreciation system (described in Section 6 of this chapter) rather than the ADR system. In addition, California S Corporations are not subject to the Alternative Minimum Tax. (See Section 13 of this chapter.)

11. CAPITAL GAINS AND LOSSES

Capital gains are profits from the sale of property and other capital assets. Capital assets are defined as all property except the following: inventories, property held for sale in the ordinary course of business, depreciable business property, and real property used in business. Capital assets include real property (land and buildings), personal property, and intangible assets (such as stock).

Capital gains are measured as the difference between the amount realized when the asset is sold and the asset's basis (normally the original purchase price). Any amounts invested in improvements are added to the basis; costs of the sale are deducted from the sales price. The gain is generally recognized in the year the asset is sold or exchanged.

Capital gains classified as a different type of income from the "ordinary income" of a corporation arising from its trade or business activities. Under both federal and California law, corporate capital gains are taxed the same as ordinary income; that is, they are fully includible in income subject to tax. Under California and federal law, corporate capital losses may be fully deducted against capital gains, but excess capital losses cannot be deducted against ordinary income. Both California and federal law provide that these excess losses may be carried forward for five years and deducted against capital gains in future years. Both laws allow 100% capital loss carryforwards. Federal law, but not California, permits a three-year carryback in addition to the carryover.

12. TAX CREDITS

Tax credits reduce tax liability dollar for dollar, but not below the annual minimum tax, if applicable. Thus, they operate differently from deductions, whose value in reducing tax liability equals the amount of the deduction multiplied by the highest marginal tax rate to which the taxpayer is subject. (See Section 5 of this chapter.)

Tax credits available under the corporation tax are intended to provide businesses incentives to engage in certain activities that are socially or economically desirable. Most credits are also available to businesses that file under the Personal Income Tax Law. The amount of tax credits allowable in any taxable year may be limited by the taxpayer's alternative minimum tax liability or by tentative minimum tax. (See Section 12 of this chapter for further information.)

Some of the tax credits allowed in state law are similar to credits offered in federal law. However, in most cases the federal credit amounts are greater. This is because the federal tax burden is more than four times greater than California's. This can be seen by comparing the rate structures: California's corporate rate is 8.84%, while the top federal corporate rate is 38%. As a result, many state income tax credits patterned after federal credits are roughly one-fourth the size of the federal credit.

Several of the major credits in California Corporation Tax Law are described below:

Manufacturers' Investment Tax Credit (MIC). [NOTE: Due to the decrease in the number of manufacturing jobs in California as of January 2003, the MIC expired on January 1, 2004. The discussion that follows is presented for historical perspective.] California law allowed a tax credit equal to 6% of qualified property placed in service after January 1, 1994. Qualified property was limited to certain manufacturing equipment used in specific industries. In general, the property must be tangible personal property; however, "special purpose buildings and foundations" for certain electronics manufacturers, semiconductor equipment manufacturers, biotechnology or biopharmaceutical manufacturers, aerospace manufacturers, and manufacturers of custom or prepackaged computer software also qualified for the credit.

A lessee of qualified property could claim the credit as long as the lessor paid the sales and use tax upon acquiring the equipment.

The credit was claimed against the regular tax and could reduce the regular tax below tentative minimum tax for alternative minimum tax (AMT) purposes. Unused credits could be carried forward for up to eight years (ten years for "small" businesses less than $50 million in gross receipts during the year for which the credit is allowed).

Additionally, the credit program allowed a new business the option of a state sales tax exemption on qualifying manufacturing equipment during its first three years of operation (e.g., a start-up firm can either claim the 6% income tax credit or the 5% sales tax exemption). Because the size of the sales tax exemption was tied to the General Fund sales tax rate, the exemption decreased from the 5% level to 4-3/4% for calendar year 2001, and increased to 5% beginning with calendar year 2002. (See Chapter 2E for a discussion of the Sales and Use Tax.)

Rice Straw Credit. California law allows a tax credit equal to $15 for each ton of rice straw that is grown in California and is purchased by a taxpayer. The credit is limited to an aggregate annual amount of $400,000 for all taxpayers. It is allowed only if the purchaser is the "end user" of the rice straw. The "end user" is defined as anyone who uses the rice straw for processing, energy generation, manufacturing, export, prevention of erosion, or for any other purpose, except open burning, which consumes the rice straw. The taxpayer who is allowed the credit cannot be related to the person who grew the rice straw.

The Department of Food and Agriculture (DFA) is responsible for certifying and allocating this credit. Credits are allocated on a "first come, first served" basis.

Taxpayers are required to provide DFA with certain documentation and to retain and provide a copy of any certification to the FTB upon request.

The rice straw credit applies to taxable years beginning on or after January 1, 1997 and before January 1, 2008. This credit may be carried over for up to 10 years and may not reduce the tax below tentative minimum tax for AMT purposes.

Donated Agricultural Product Transportation Credit. Taxpayers may claim a tax credit equal to 50% of the costs for transporting donated agricultural products to a nonprofit organization.

Upon receipt or delivery of the donated agricultural product, the nonprofit organization must provide the transporter a certificate signed and dated by an authorized representative of the organization. The certificate must state the name and address of the recipient organization, the type and quantity of the product donated, the distance the product was transported, the name of the transporter and the taxpayer donor, and that the product was donated pursuant to the Food and Agriculture Code. The taxpayer must provide a copy of the certificate to FTB upon request.

The agricultural products transportation credit applies to taxable years beginning on or after January 1, 1996. This credit may be carried over until exhausted and may not reduce the tax below tentative minimum tax for AMT purposes.

Farmworker Housing Credit. For both personal income and corporation taxpayers, California law allows a 50% credit for the qualified costs of construction or rehabilitation of qualified farmworker housing beginning January 1, 1997.

For banks and financial corporations, California law also allows a 50% credit on below-market rate loans used to finance the construction or rehabilitation of qualified farmworker housing. The credit equals 50% of the difference between the amount of interest income that would have been collected by a bank or financial corporation had the loan rate been one point above prime and the lesser amount of interest income actually due for the term of the loan.

The aggregate amount of both credits available for allocation cannot exceed $500,000 for any taxable year. However, any unallocated credits left over during one year may be carried forward for allocation during subsequent years.

The farmworker housing credit applies to taxable years beginning on or after January 1, 1997 and continues indefinitely. This credit may be carried over until exhausted and may not reduce the tax below tentative minimum tax for AMT purposes.

Disabled Access Credit. For both personal income and corporation taxpayers, California law allows a 50% credit to eligible small businesses for expenses incurred up to $250 to comply with the federal Americans with Disabilities Act of 1990. The disabled access credit applies to taxable years beginning on or after January 1, 1996 and continues indefinitely. This credit may be carried over until exhausted and may not

reduce the tax below tentative minimum tax for AMT purposes. There is also a comparable federal credit.

Enhanced Oil Recovery Credit. Federal law allows taxpayers an enhanced oil recovery credit that is combined with several other credits to form the general business credit.

This credit is allowed in an amount up to 15% of the taxpayer's qualified enhanced oil recovery costs. The qualified costs are defined as amounts paid or incurred for qualifying tangible property that may be depreciated or amortized and are an integral part of a qualified enhanced oil recovery project involving one or more tertiary recovery methods. If a credit is allowed for these costs, the amount otherwise deductible or required to be depreciated or recovered through depletion must be reduced by the amount of the allowable credit.

The California enhanced oil recovery credit amount is one-third of the taxpayer's allowed federal enhanced oil recovery credit. The state credit applies only to oil recovery projects located within California.

A taxpayer's election not to take the credit for federal purposes prevents the taxpayer from claiming a state credit.

The enhanced oil recovery credit applies to taxable years beginning on or after January 1, 1996 and continues indefinitely. This credit may be carried over for up to 15 years and may not reduce the tax below tentative minimum tax for AMT purposes.

Community Development Financial Institution Deposit Credit. Under the Corporation Tax Law, and the Personal Income Tax Law a credit is allowed for 20% of the amount of each "qualified deposit" into a "community development financial institution" (CDFI). A qualified deposit is defined, as is equal to or greater than $50,000 and made for a minimum duration of 60 months. A CDFI is defined as a private financial institution located in California and certified by the California Organized Investment Network (COIN) as an entity with community development as its primary mission. CDFIs may lend in urban, rural, or reservation-based communities in California. A CDFI may include a community development bank, a community development loan fund, a community development credit union, a micro-enterprise fund, a community development corporation-based lender, and community development venture fund.

The aggregate amount of qualified deposits made by all taxpayers is limited to $10 million for each calendar year, thus limiting the value of the credit to $2 million annually.

Any previously allowed credit will be recaptured if the qualified deposit is withdrawn before the end of the 60th month and not re-deposited or reinvested in another CDFI within 60 days. However, the recapture penalty is lower if the full amount invested is not withdrawn. An amount equal to 20% of any reduction in the qualified deposit will be recaptured if the qualified deposit is reduced before the end of the 60th month, but not below $50,000.

This credit is effective for taxable years beginning on or after January 1, 1997 and before January 1, 2007. This credit may be carried over for up to four years and may not reduce the tax below tentative minimum tax for AMT purposes.

Joint Strike Fighter Credits. A special wage credit and property credit are provided for taxpayers under initial contract or subcontract to manufacture property for ultimate use in a Joint Strike Fighter (JSF) program. A JSF is a multi-service, multinational project conducted by the U. S. government to develop and produce the next generation of air combat strike aircraft. The credits are available for taxable years beginning on or after January 1, 2001 and before January 1, 2006. Any excess credits can be carried forward for up to eight years. No credit is allowed unless the bid upon which the JSF contract or subcontract is reduced by the credit amount.

The JSF wage credit is equal to a specified percentage (50% for 2001, 40% for 2002, 30% for 2003, 20% for 2004 and 10% for 2005) of employee wages that are allocable to property manufactured in California for ultimate use in a JSF. The wages can be paid to new or existing employees whose work is at least 90% directly related to the contract or subcontract to manufacture property for use in a JSF. The credit is limited to $10,000 per year, per employee, and is prorated for employees that are qualified employees for partial years.

In general, JSF property credit is patterned after the MIC. It is equal to 10% of the cost of the qualified property and capitalized labor costs used to manufacture a product for ultimate use in a JSF. The taxpayer is not allowed to claim both this credit and the MIC for the same property.

Employer-Provided Child Care. California allows credits to employers under both the personal income tax and the corporation tax for providing child care services to their employees.

Specifically: (a) a 30% credit is allowed to employers or building owners for the costs of start-up expenses related to establishing or expanding a child care program or constructing an on-site or near-site child care facility for employees' or tenants' dependents; (b) a 30% credit is allowed for employer costs to operate child care information and referral services, with a maximum dollar credit; and (c) a 30% credit is allowed for employer contributions to child care arrangements for employees' children under the age of 12, such as on-site service, center-based service, home provider care or in-home care; this credit cannot exceed $360 per year per child. Only amounts paid directly by employers to child care providers qualify for the credit. These credits sunset at the end of 2006. There are no comparable federal credits.

Low Income Housing Construction and Rehabilitation. California allows a tax credit against the personal income tax, corporation tax, and insurance gross premiums tax for construction or rehabilitation of low-income housing in California. The credit is equal to 30% of amounts invested and is claimed over four years (9%, 9%, 9%, and 3%). Except in certain cases, it is available in addition to the comparable credit offered under federal

law (9% annually for 10 years for nonsubsidized housing, 4% annually for 10 years for subsidized housing).

To qualify for the state credit, a taxpayer must receive an allocation from the Tax Credit Allocation Committee, and the rents must be maintained at low-income levels for 30 years (compared to 15 years for the federal credit). For buildings located in certain areas or census tracts, the federal credit must be reduced for the state credit to be claimed.

Corporations may elect to assign any portion of the credit to an affiliated bank or corporation. This credit can reduce regular tax below tentative minimum tax. The state credit will remain in effect as long as the federal credit remains in effect. The federal credit was made permanent by the Revenue Reconciliation Act of 1993. Federal law provides more than $50 million in credits annually to California. California offers $70 million in state credits.

Research and Development Expenditures. California allows a tax credit under the personal income tax and the corporation tax for incremental research and development expenditures made during the year. The credit is closely patterned after the federal credit for qualified research expenses. SB 705 (Sher), Chapter 77, Statutes of 1999, increased the credit from 11% to 12% of the excess of the qualified research expenses over a specified percentage of the average annual gross receipts for the four preceding taxable years (i.e., the base amount). The percentage was increased to 15% by AB 511 (Alquist), Chapter 107, Statutes of 2000. This credit can reduce regular tax below tentative minimum tax and is allowed indefinitely.

In addition, taxpayers may elect an alternative incremental research credit, which is substituted for the regular research credit. If a taxpayer makes this election, the taxpayer is assigned a three-tiered fixed base percentage that is lower than the fixed base percentage allowed under the general research credit.

Enterprise Zones (EZs), Targeted Tax Areas (TTAs), Manufacturing Enhancement Areas (MEAs), and Local Agency Military Base Recovery Area (LAMBRA) Incentives. California provides an array of tax incentives to businesses and their employees located in designated EZs, TTAs, MEAs and LAMBRAs. These designated zones and areas are economically depressed areas of the state designated by the Department of Housing and Community Development. Special incentives include:

- For EZs. A tax credit for sales or use taxes paid on the purchase of qualified machinery and machinery parts, (which can reduce regular tax below tentative minimum tax (TMT); a tax credit to employers for wages paid to qualified employees working in the zone (which can also reduce regular tax below TMT); a tax deduction for net interest income arising from loans made to zone businesses; expensing of all or part of the cost of qualified property; and a special 15-year, 100% net operating loss carryover to offset zone income.

- For TTAs. A tax credit for sales or use taxes paid on the purchase of qualified machinery and machinery parts, a tax credit for wages paid to qualified

employees working in the targeted tax area, expensing of all or part of the cost of qualified property, and a special 15-year, 100% net operating loss carry-over to offset targeted tax area income. Both credits can reduce regular tax below tentative minimum tax.

- For MEAs. A credit for wages paid to qualified employees working in the MEA.

- For LAMBRA. A tax credit for sales or use taxes paid on the purchases of qualified machinery and machinery parts; a tax credit to employers for wages paid to qualified employees working in the area; expensing of all or part of the cost of qualified property; and a special 15-year, 100% net operating loss carryover to offset area income.

These tax advantages are available during the 15-year life of each designated EZ, TTA, or MEA, and during the eight-year life of each designated LAMBRA. Federal law provides limited benefits to a very small number of "Empowerment Zones" and "Enterprise Communities". Some of these federal zones partially overlap California's geographically-based economic incentive areas. Regions of overlap include Los Angeles, Santa Ana, San Diego, San Francisco, Oakland, Imperial County, Watsonville, and Fresno.

Prior Year Alternative Minimum Tax (AMT) Credit. While AMT ensures that a taxpayer's tax liability is not reduced to zero by tax preferences, the intent is not to eliminate the use of the tax preferences, but to defer them. (See Section 12, following, for a discussion of AMT.) The prior year AMT credit is allowed for AMT paid in a prior year by taxpayers that are not liable for AMT in the current year. The amount of the allowable credit in any tax year is limited to the regular tax less the refundable credits (with no carryover provisions and the credit for taxes paid to other states). The credit may be claimed by both personal income and bank and corporation tax filers.

Prison Inmate Labor. A credit is allowed for 10% of the amount of wages paid to each prisoner employed in a joint venture pursuant to an agreement with the Director of Corrections.

13. ALTERNATIVE MINIMUM TAX (AMT)

Corporate taxpayers that take advantage of certain tax preferences (exemptions, deferrals, or deductions) must compute an AMT at a 7% rate and pay this if it exceeds the amount of regular tax due. The purpose of AMT is to ensure that taxpayers who take advantage of special tax reduction provisions in the tax code pay at least some minimum amount of tax on income receiving preferential treatment. These AMT rules generally conform to federal law, which imposes the corporate AMT at a 20% rate.

Computation of the AMT is rather complex. In simplified terms, the taxpayer is required to first compute the regular tax, using the rules described in this chapter and applying the regular corporate rate of 8.84%. Then the taxpayer must compute the "tentative

minimum tax," which is calculated by including more income and by adding back certain tax preferences that were claimed during the first calculation, then subtracting an exemption amount ($40,000 for corporations) and applying the AMT tax rate of 7% to the difference. If the "tentative minimum tax" is higher than the computed regular tax, then the difference is the AMT due, which must be paid in addition to the regular tax.

A simple example of this procedure is shown in Table 5.

These rules for corporations generally apply to personal income taxpayers as well.

AMT has an important interaction with tax credits. Most credits can reduce regular tax down to, but not below, TMT. However, specific credits are available to reduce regular tax below TMT to determine a taxpayer's regular tax liability. These specific credits are:

- Enterprise zone hiring credit;
- Enterprise zone sales or use tax credit;
- Program area hiring credit carryover;
- Program area sales or use tax credit carryover;
- Los Angeles Revitalization Zone (LARZ) construction hiring credit carryover;
- LARZ hiring credit carryover;
- LARZ sales or use tax credit carryover;
- Targeted Tax Area hiring credit;
- Solar energy credit carryover;
- Commercial Solar energy credit carryover;
- Commercial Solar electric system credit carryover;
- Research and development credit;
- Orphan drug credit carryover;
- Low-income housing credit;
- Other state tax credit; and
- Manufacturers' investment credit carryover.

In addition, the solar energy credit carryover and commercial solar energy credit carryover can reduce a taxpayer's alternative minimum tax liability.

TABLE 5

EXAMPLE: COMPUTATION OF ALTERNATIVE MINIMUM TAX (AMT)
FOR A HYPOTHETICAL CORPORATION

Regular Tax Computation:

1) Income of $500,000 less deductions of $300,000 =
Net Income of $200,000 times 8.84% rate =

Regular Tax of $17,680

2) Tentative Minimum Tax Computation:

Income of $500,000 less deductions of $300,000
plus income adjustments of $50,000 plus tax preferences added back of $100,000 =
Alternative Minimum Taxable Income of $350,000 *less* exemption of $40,000 =
$310,000 times 7.0% rate =

Tentative Minimum Tax of $21,700

3) **Difference** between Tentative Minimum Tax and Regular Tax
[$21,700 less $17,680] =

AMOUNT of . . . . $ 4,020

4) Total Tax Computation:

Regular Tax plus AMT [$17,680 plus $4,020] =

Total Tax Liability of. $21,700

Tax preference items and required adjustments are generally similar to those in federal law. Specific rules for computing each of these are provided in the law.

14. TAX EXEMPT ORGANIZATIONS

In 2004, approximately 88,000 organizations filed returns as exempt from the corporation tax. In general, these organizations can be described as nonprofit educational, religious, charitable, literary, scientific, civic, fraternal, and social organizations. State and federal rules for qualifying as a tax-exempt organization are nearly identical.

There are restrictions on the amount of lobbying in which such organizations may engage and retain their tax-exempt status.

Certain nonprofit business and labor organizations, chambers of commerce, real estate boards, cemeteries, certain political organizations, and various beneficiary and retirement organizations may qualify for tax exempt status.

Almost all organizations that are exempt from the corporation tax nonetheless are subject to tax on "unrelated business income" (UBI) in excess of $1,000 per year. The UBI is income from a trade or business activity that is regularly carried on and is not related to the organization's exempt purpose. The tax rate on UBI is the regular corporate rate of 8.84%. Businesses that are taxed on UBI are not subject to the minimum franchise tax.

15. REVENUE

The corporation tax is the third largest source of General Fund revenue. In fiscal year (FY) 2004-05 it generated approximately $8.7 billion (approximately 10.8% of General Fund revenues). The tax is expected to raise $9.6 billion in FY 2005-06.

16. ADMINISTRATION

The FTB administers the corporation tax, and also is charged with setting the bank tax rate each year.

Estimated payments of tax liability are due in quarterly increments of 25% of estimated liability each, beginning 4 months and 15 days after the beginning of the taxable year. The first estimated tax payment may not be less than the minimum franchise tax, if applicable. Additional payments of 25% of estimated tax are due on the 15th day of the 6th, 9th, and 12th months of the taxable year. Taxpayers are subject to penalties if estimated payments remitted over the course of the year are less than prescribed minimum percentages of tax liability.

Returns are due on the 15th day of the third month following the close of the taxable year.

Taxpayer appeals of disputed tax assessments are made first to FTB, then to the Board of Equalization (BOE). After payment, taxpayers may appeal in the courts.

Taxpayers may post deposits with FTB in lieu of paying disputed tax assessments. Taxpayer appeals of denied refund claims may be made either to the BOE or in state court.

The paperless automatic extension program, similar to the program for personal income taxpayers, grants a seven-month automatic extension of time to file the tax return for all corporations that are not suspended. California banks and corporations are still required to pay 100% of the current tax liability by the 15th day of the third month following the close of the taxable year. Taxpayers who owe additional tax would be required to send in their payment coupon by their original due date.

As under current law, taxpayers who do not pay 100% of the tax liability by their original due date will owe interest and will be assessed the late payment penalty. A return filed by the extended due date, with or without 100% of the tax liability paid by the original due date, will be considered to be a timely filed return.

Electronic Funds Transfer Requirement. Taxpayers subject to the Corporation Tax Law and that meet certain requirements must pay all tax liabilities, both estimated payments and any tax due with the return, via electronic funds transfer.

In general, taxpayers subject to Corporation Tax Law must pay via electronic funds transfer if any quarterly estimated tax payment exceeds $20,000 or their total tax liability exceeds $80,000. In addition, any taxpayer may use electronic funds transfer if FTB grants permission to a request from the taxpayer.

17. CODE

California Constitution, Article XIII, Sections 26 and 27

Revenue and Taxation Code, Division 2, Part 10.2, Sections 18401-19802 and
Part 11, Sections 23001-25141