

Memorandum

570.0335

Date: October 6, 1997

To : Mr. David Rivera, Jr.
Staff Tax Auditor
Fresno District Administrator

From : Janice L. Thurston
Tax Counsel

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Subject: Research and Development Credits on Federal
Income Tax Returns
E--- M--- Co., Inc.
S- -- XX-XXXXXX

This is in response to your August 26, 1997 memorandum asking whether a research and development credit on a taxpayer's federal income tax return constitutes a use subject to tax. For the reasons stated in this memorandum, the research and development credit does not constitute a use subject to tax.

Your memorandum states that an audit of E--- M--- Co., S- -- XX-XXXXXX was recently completed on July 15, 1997 and the supervisor requested a legal opinion regarding the issue stated above before proceeding further in the appeals process, and the taxpayer concurred. You mentioned annotations involving depreciation and investment tax credits on federal income tax returns, citing Sales and Use Tax Annotation 330.1878 as an example. You attached two documents from the taxpayers' representative, R--- D---, CPA, dated June 18, 1997 and August 18, 1997. The June 18 document entitled "E--- M--- Memorandum on Manufacture and the Sale of Product" provided information on a sale of equipment as an example of a project in which E--- M--- Co. receives an income tax benefit for research and development expenditures in the form of a deduction, while the August 18, 1997 letter discusses the research and development credit for federal income tax purposes. You stated that the taxpayer has valid documentation that the sale of equipment is exempt from sales tax.

Since you have concluded that the sale by E--- M--- Co. is exempt from sales tax and have asked only whether the taking of a research and development credit constitutes a use subject to tax, I assume that you have concluded that E--- M--- Co. is not otherwise subject to use tax, e.g., pursuant to Regulation 1501.1 in which persons who are in the business of rendering services pursuant to a qualified research and development contract are consumers of tangible personal property which they use incidentally in rendering the service.

A use tax is imposed on the storage, use or other consumption in this state of tangible personal property purchased from any retailer for the storage, use or other consumption in this state. (Rev. & Tax. Code § 6201.) “Use” is defined as including “the exercise of any right or power over tangible personal property incident to the ownership of that property . . . except that it does not include the sale of that property in the regular course of business.” (Rev. & Tax. Code § 6009.) The question of whether a research and development credit on a federal income tax return constitutes a “use” as defined in Revenue and Taxation Code section 6009 can only be answered in the affirmative if the events that entitle a taxpayer to a research and development credit are also events that necessarily involve a use of tangible personal property.

In other areas of federal tax law, events that allow a taxpayer to take a federal depreciation deduction for tangible personal property necessarily involve a “use” as defined in Revenue and Taxation Code section 6009. In a case where horses were treated as depreciable assets for federal and state income tax purposes, the court, in determining that there was a taxable use, found that the taxpayer considered the horses to be capital assets, not property held for sale in the ordinary course of business “since inventory or property held for sale in the ordinary course of business is *not* subject to a depreciation allowance as a capital asset” *McConville v. State Board of Equalization* (1978) 85 Cal.App.3rd 156, 161. Therefore, in order for depreciation deductions of tangible personal property to be properly taken, the taxpayer must consider the property depreciated to be a capital asset, not property held for sale in the ordinary course of business, thereby making the use of depreciable tangible personal property subject to use tax liability, if the requirements for the imposition of use tax under Revenue and Taxation Code section 6201 are otherwise met.

The taking of an investment tax credit for tangible personal property also necessarily involves a “use” of property. A taxpayer may obtain a federal investment tax credit under Internal Revenue Code section 46 (equal to the sum of the rehabilitation credit, energy credit and reforestation credit) based in part upon the taxpayer’s qualified investment in certain tangible depreciable property. Since the taking of an investment tax credit for tangible personal property necessarily requires that property be depreciable, there has then been a “use” of property within the meaning of Revenue and Taxation Code section 6009, subjecting the taxpayer to use tax liability if the requirements for imposition of use tax are otherwise met. (See also, Sales and Use Tax Annotation 330.1878 (1/16/87).)

The question here presented is whether the events that allow a taxpayer to take a research and development credit on its federal income tax return are also events that involve a use of property under Revenue and Taxation Code section 6009. Internal Revenue Code section 41 provides an income tax credit for certain qualified research expenditures. (Please note that the qualified research expenditures under Internal Revenue Code section 41 also may be eligible for the research deduction under Internal Revenue Code section 174.) Unlike the events giving rise to depreciation deductions and investment tax credits, the events giving rise to a research and development credits do not necessarily involve a use of tangible personal property within the meaning of Revenue and Taxation Code section 6009 for the reasons set forth below.

A taxpayer otherwise meeting the requirements of Internal Revenue Code section 41 may take a research credit equal to a certain percentage of its expenditures for “qualified research expenses” and “basic research payments.” “Qualified research expenses” are the sum of “contract research expenses” and “in-house research expenses,” while “basic research payments” are payments made to a qualified organization for basic research. “Contract research expenses” are paid to persons other than employees for qualified research, and “in-house research expenses” are expenses that satisfy any one of three conditions:

1. Expenses are for wages paid or incurred to employees for qualified services performed by the employee;
2. Expenses are amounts paid or incurred for supplies, which are defined as any tangible property, other than land or improvements to land, and other than property for which depreciation deductions are allowable; and
3. Expenses are amounts paid or incurred to another person for the right to use computers in the conduct of qualified research.

A research and development credit may be taken for any one or more of the qualifying expenditures discussed above. Since the research and development credit could be taken solely for an item not subject to sales or use tax, such as wages, the mere taking of a research and development credit on a federal income tax return does not mean that the taxpayer has made a “use” of tangible personal property within the meaning of Revenue and Taxation Code section 6009. Therefore, the taxpayer’s taking of an research and development credit on a federal income tax return will not, by itself, constitute a “use” under Revenue and Taxation Code section 6009. A research and development credit is unlike a depreciation deduction or investment tax credit involving tangible personal property which does require a “use” of tangible personal property in order for the taxpayer to take the income tax deduction or investment credit.

If you have any further questions, please write again.

JLT/cmm

cc: --- District Administrator (--)