

## **A Review of the Development of California's MIC Regulations**

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### **Introduction**

This article provides a comprehensive review of the development and adoption of the regulations that implement California's Manufacturers' Investment Credit (MIC). The Franchise Tax Board (FTB) promulgated these regulations in 1996. This article is based upon documents contained in the FTB's official Rulemaking File that served as the basis for the MIC regulatory project. It will provide insights into the FTB's decisions concerning specific regulatory language adopted and allow taxpayers to better understand the complex FTB regulations.

### **Background on MIC Statute**

In 1993, California enacted a 6% investment tax credit and a partial (equal to 5%) sales/use tax exemption for the purchase of certain property (generally machinery and equipment) purchased for use by manufacturers (*See* California Revenue & Taxation Code [CRTC] §§ 17053.49

(personal income tax law) and 23649 (corporation tax law) [for the MIC] and 6377 [for the partial exemption]). The MIC statute has three major requirements:

- *Qualified Taxpayer Definition* -- For purposes of the MIC, the law provides that a “qualified taxpayer” is any taxpayer who falls within Standard Industrial Classification (SIC) Codes 2011 to 3999 (which is Division D, “Manufacturing”), or 7371 to 7373 (software developers) of the SIC Manual, 1987 edition. Generally, a qualified taxpayer may be an individual, partnership, C or S corporation, limited liability company, trust, or estate.
- *Qualified Property Definition* -- There are four major requirements for property to qualify for the MIC: It must be (1) tangible personal property, (2) which is depreciable or amortizable under Internal Revenue Code Section 1245(a), (3) which is “primarily used” in the manufacturing or a related process, (4) which is placed in service in California on or after January 1, 1994.
- *Qualified Cost Definition* – In addition, to qualify for the MIC, sales tax must be paid on the qualified property, and the costs must be properly chargeable to the taxpayer’s capital account
- *Sunset Date* -- The MIC and partial exemption statutes will be repealed if 100,000 jobs in the manufacturing sector are not created by January 1, 2001, or on January 1 of the earliest year thereafter. However, the MIC can be carried forward after that event as provided by the statute.

### **Contents of Official Rulemaking File**

The official FTB Rulemaking Files include the following documents:

#### VOLUME 1

- Background Material
- Agency Approval and Fiscal Impact Statement
- Revenue Impact and Economic Impact Statements
- Notice of 2/13/96 Hearing (Mailed 12/28/95; Published 12/29/95)
- Initial Statement of Reasons
- Proposed Regulations
- Affidavit of Mailing
- Plain English Statement
- Comments Received During 2/13/96 Comment Period
- 12/22/95 Letter Requesting Assistance in Developing Financial Information Relative to the Clean Air Act

- Letters Received in Response to 12/22/95 Letter
- Staff Response to Comments
- Proposed Changes Presented at the 2/13/96 Hearing
- Transcript of 2/13/96 Regulation Hearing
- Board Resolution
- Notice of 15-day Changes (mailed 2/29/96; Published 3/1/96)
- Text of Regulation Mailed with 15-day Notice
- Affidavit of Mailing
- Summary of Comments and Recommendations
- Updated Informative Digest
- Final Statement of Reasons

## VOLUME 2

- Addendum to the Final Statement of Reason
- Text as Sent to OAL on 3/20/96
- Text as Filed with SOS on 5/1/96

## **Background Materials for Rulemaking**

- The following items were included as background materials for the FTB Rulemaking Files:
- Senate Bill 671 (Stats. 1993, Ch. 881), adding CRTC Sections 17053.49/23649
- Senate Bill 676 (Stats. 1994, Ch. 751), amending CRTC Sections 17053.49/23649
- State Board of Equalization Regulation Section 1525.2, implementing CRTC Section 6377 (partial exemption for manufacturing equipment)
- Similar Laws in Other States (copies of statutes and regulations from the following states were included: Indiana, Wisconsin, Missouri, Georgia, Colorado, Arizona, Arkansas, New York, Connecticut, New Jersey, Illinois, Maine)
- FTB Notice 94-7 (Issued 12/16/94) - FTB Pre-Drafting Symposium on Proposed Regulations for MIC
- FTB Notice 95-2 (issued 5/16/95) Request for Public Comment on Proposed MIC Regulations

- FTB Notice 95-3 (issued 7/12/95) MIC Draft Proposed Regulations Extension of Comment Period to August 25, 1995

## **FTB Notices Concerning the MIC**

### FTB Notice 94-5 (issued November 23, 1994)

#### Request for Public Comment; Drafting of Proposed Regulations on MIC

CRTC Sections 17053.49 and 23649 were enacted by SB 671 (Stats. 1993, Ch. 881) and amended by SB 676 (Stats. 1994, Ch. 751). These sections generally provide a six percent credit for certain property used in a qualified manufacturing or similar activity conducted in California. The FTB will soon release FTB Publication 1137 - The MIC, which provides more detailed information about this credit.

The FTB intends to draft and subsequently adopt regulations under Sections 17053.49 and 23640 to interpret certain provisions of these sections and to provide further guidance to affected taxpayers. In particular, the FTB staff has preliminarily identified the following issues as needing further clarification by regulation:

1. Defining the beginning and the end of the manufacturing process.
2. Clarifying the determination of who is a “qualified taxpayer.”
3. Providing specific rules applicable to “turn-key” and other fixed-price construction contracts.
4. Further defining “recycling.”
5. Further defining “research and development.”
6. Clarifying the reporting requirements applicable to successor lessors.
7. Defining capitalized labor costs.
8. Defining binding contracts, including option contracts.
9. Further defining special purpose buildings.

### FTB Notice 94-7 (issued by December 16, 1994)

#### FTB Pre-Drafting Symposium on Proposed Regulations for the MIC

FTB staff will conduct a one-day symposium on January 17, 1995 in Sacramento to solicit input on proposed regulatory action concerning the MIC. The symposium will be an informal open discussion forum for the sole purpose of identifying possible issues prior to drafting the proposed regulations. This symposium will not constitute part of the formal regulatory process.

### Comments Received from 1/17/95 Symposium

Five written comments were received from interested parties from the January 17, 1995 symposium, including one from the author. The first letter proposed a definition of “biopharmaceutical activities,” which was actually put into the bill by SB 38 in 1996. The

second letter recommends clarification of “handling equipment used on the premises to move material prior to finished goods storage,” as well as the language related to capital accounts.

The third letter, submitted by the author, addressed the definition of the beginning and end of the manufacturing process, clarification of the determination of who is a “qualified taxpayer,” further definition of “recycling,” further definition of “research and development,” clarification of the reporting requirements applicable to successor lessees, defining capitalized labor costs, defining binding contract, including option contracts; further defining special purpose buildings; definition of extraction process; recordkeeping requirements; new versus used equipment; wine barrels; pass-through entities; and, a safe harbor.

The fourth letter made recommendations concerning the definition of the beginning and end of the manufacturing process; providing specific rules applicable to “turn-key” and other “fixed-price” construction contracts; expanding the definitions of “manufacturing” and the manufacturing process; capitalization of indirect costs; binding contracts; asset basis; and, the recapture provisions.

The fifth letter urged clarification whether recyclers of metal, glass, plastics, and paper qualify for the MIC.

### **Informal Comments to June 1995 Draft Regulations**

- The following groups and individuals submitted informal comments to the FTB:
- Western States Petroleum Associations (WSPA)
- Bank of America
- American Electronics Association (AEA)
- Air Products
- Comdisco
- New United Motor Manufacturing, Inc. (NUMMI)
- Mitsubishi Capital, Inc.
- Chevron Corporation
- California Chamber of Commerce

Because identities were redacted in the FTB’s Rulemaking File, it is not known precisely what each of the above organizations wrote. However, copies of unidentified letters were reviewed.

The first letter argued that the regulation incorrectly limits the scope of property that qualifies because all IRC Section 1245(a) property used in the manufacturing process should qualify.

The second letter discussed the following items: definition of “qualified property” is too narrow to be limited to only IRC Section 1245(a)(3)(A) property; definition of “capitalized labor” is too narrow; freight costs should be included within the definition of “qualified cost”; clarification of the capitalization requirement and whether costs must be “chargeable” or “charged” to the

capital account; definition of “placed in service” is too narrow; recapture rules and definition of “disposition” is too narrow; the requirement to specifically identify sales and use tax paid is too limited; a definition of pollution control was recommended; and, the need to specify an ordering of credits.

The third letter addressed the following issues: definition of capitalized labor; “placed in service” definition; “pollution control” definition; “recycling” definition; “research and development” definition; definition of “qualified taxpayer” and the accompanying establishment classification rules; “qualified costs” definition and the “properly chargeable to a capital account” requirement; sales and use tax payment requirement; freight charges; “qualified property” definition; special purpose buildings definitions; recapture rules; and, the ordering of credits.

The fourth letter addressed the definitions of “capitalized labor,” “pollution control,” “recycling,” “research and development,” “qualified taxpayer,” and “qualified property.” In addition, comments were made concerning the recapture rules and recordkeeping requirements.

The fifth letter pertained to leasing transactions and a recommendation to include other examples to be used in the regulation.

The sixth letter concerns the sales tax refund set forth in CRTC Section 6902.2. Also, the letter made the points that: the qualified taxpayer, as ultimate purchaser of the qualified property, is the appropriate party to claim a refund for sales or use tax; the regulations should allow qualified taxpayers to claim the difference between six percent of qualified investment and the sales tax refund as a credit against income; qualified taxpayers should be able to apply for the sales tax refund at the earliest possible date to ensure that the MIC and the sales tax refund remain parallel tax incentives; the draft regulation serves treatment of pass-through entities.

The seventh letter states that the regulation unduly emphasizes the option price as the criterion for determining whether a lease is a finance lease or a true lease; a disposition should not include an acquisition sale and leaseback or a financing transaction.

The eighth letter discussed the proposed definition of “capitalized labor,” recordkeeping requirements, and the definition of “qualified costs.”

The ninth letter raised the following issues: the regulations do not directly address credit availability if “used” qualified equipment (whether leased or purchased) is moved into the state; the definition of “primary” and the provisions concerning dual-use property; binding contracts language; clarification of the period when the lessee claims the credit if the lessor’s payment of sales tax is made in a different period; the transition election to pay sales or use tax to claim the MIC; requirement that the lessor provide a report to the lessee; recordkeeping and substantiation requirements for the MIC, particularly in the context of leasing transactions.

The tenth letter raised several scenarios that should qualify for the MIC in instances of non-abusive leasing transactions.

The eleventh letter raised a number of leasing issues under the MIC, including: Synthetic leases; sale-leaseback transactions; movement of used equipment in California; definition of “primarily” and dual use property; purchase options under leases; timing of sales/use tax payment

requirement; timing of availability of credit to lessee; transition elections; lessor reporting requirements; recordkeeping requirements.

The twelfth letter proposed language for inclusion in the regulation to address “synthetic leases.”

The thirteenth letter concerning the provisions of the regulation dealing with acquisition sale and leaseback transactions, as well as specific issues relating to dispositions and the payment of sales/use tax by the lessor.

The last letter concerned the placed in service requirement and its interaction with the qualified property definition.

### **FTB Responses to Comments Received on Draft Regulations**

All letters were sent on November 28, 1995 to organizations that submitted written comments to the draft regulations. The comments were based upon the June 9, 1995 draft of the proposed MIC regulations.

#### Tangible Personal Property That Is Defined in IRC Section 1245

Several letters requested changing the qualified property definition so that it “meets the objectives of the Legislature” by following the mandate set by the “spirit” of the MIC. However, as outlined below, FTB staff believes that it has no authority to make the changes you suggest.

For purposes of the MIC, the term “qualified property” includes “[t]angible personal property that is defined in Sections 1245(a) of the Internal Revenue Code...” Section 1245(a)(3) of the IRC provides, in pertinent part, that IRC Section 1245(a) property includes...” (A) personal property.” Treasury Regulation Section 1.1245-3(b) further provides, in pertinent part, that “[t]he term ‘personal property’ means – (1) Tangible personal property (as defined in paragraph (c) of Section 1.48-1, relating to the definition of ‘section 38’ property’ for purposes of the investment credit) ...” As a result, staff believes that the definition of “tangible personal property” contained in the draft proposed regulations is entirely consistent with the statutory language.

Moreover, a review of the legislative history relating to the MIC demonstrates that the Legislature had consistently and exclusively used the term “tangible personal property” in each legislative bill relating to first the proposed sales tax exemption (AB 1313, 1993), and thereafter the MIC (SB 671, 1993; SB 1292, 1994; SB 676, 1994; SB 681, 1995; AB 397, 1995). As a result, staff believes that it is difficult to infer any other legislative intent to this issue, except that only “tangible personal property” was intended to qualify for the MIC.

Finally, while the distinction between “tangible personal property” (IRC Section 1245(a)(3)(A)) and “other tangible property” (IRC Section 1245(a)(3)(B)) may exclude certain types of property that were never specifically considered during the legislative process, staff believes that it is only appropriate to remedy any possible legislative oversight by seeking further legislative action.

#### Definition of “Capitalized Labor Costs”

The letter requests that certain “indirect” labor costs, such as design and engineering costs, as well as direct labor costs, be eligible for the MIC so long as they are “directly allocable to the



construction or modification of [qualified] property.” As you are aware, staff chose to adopt the UNICAP rules of Section 263A of the IRC as the appropriate starting point to distinguish between “direct” and “indirect” labor costs in the draft MIC regulations. Staff believes that using these UNICAP rules provides both taxpayers and the FTB with well-established rules that can be understood and administered.

In fact, the specific portion of the UNICAP rules that distinguish between direct and indirect labor costs have been in existence for over 20 years in the “full absorption” inventory tax accounting rules applicable to manufacturers under IRC Section 471 (to which California conforms).

The MIC statute includes as qualified costs “any capitalized labor costs that are directly allocable to the construction or modification of qualified property.” Staff believes that in the context of the MIC, the Legislature’s specific use of the term “directly” was intended to limit the scope of the “capitalized labor” component of the MIC to those labor costs that are actually “direct” labor costs, since absent such an intention, the term “directly” could have simply been omitted.

In fact, one of the underlying purposes for Congress’ adoption of the UNICAP rules was to provide consistent rules for specifying when “indirect” expenses incurred in connection with the self-construction of property should be capitalized and allocated to the cost of the self-constructed property, rather than currently deducted. Finally, staff believes that the UNICAP rules represent a reasonable approach for defining “direct” labor costs.

The letter specifically requests that the definition of “directly allocable capitalized labor” in the draft proposed regulations be modified to allow both direct and indirect costs of labor, as defined in the UNICAP rules of Section 263A of the IRC, to qualify for the MIC. You suggest that, since the UNICAP regulations require “indirect” labor costs to be capitalized whenever those costs “directly benefit, or are incurred by reason of the performance of production ... activities by a company for use in its trade or business,” that they should qualify for the MIC.

As a result, you suggest that the pension and other indirect labor costs should qualify for the credit as capitalized labor costs that are directly allocable to the construction or modification of qualified property. Alternatively, you suggest that staff look to certain regulations of the SBE that include “fringe benefits and payroll taxes” as direct labor costs in determining the sales price for California sales tax purposes of certain fixtures, machinery and equipment that is sold and installed by a contractor under a construction contract (SBE Regulation 1521).

With respect to your first suggestion that, since the UNICAP rules require indirect labor costs to be “capitalized” whenever those costs “directly benefit, or are incurred by reason of the performance of production,” staff believes that this requirement simply restates the general capitalization rule set forth by the U.S. Supreme Court in *Commissioner v. Idaho Power Company* (1974) 418 U.S. 1. Moreover, staff believes that the issue of when costs are required to be capitalized is not the same issue as whether such costs are directly allocable to qualified property for purposes of the MIC.

With respect to your alternative suggestion that staff use the SBE’s Regulation 1521, staff notes that the effect of these rules is to define what costs will be subject to California sales tax. If these fringe benefits and payroll taxes (of the construction contractor) are included in a third party construction contractor’s cost price for California sales tax purposes, then they would be



amounts “upon which the qualified taxpayer has paid, directly or indirectly ... [California] sales or use tax ...” and thus would qualify for the MIC as part of the qualified cost (upon which sales tax was paid) of the qualified property.

On the other hand, if staff were to adopt a similar rule for MIC purposes in the case of self-constructed property by treating such amounts as “direct labor costs” for purposes of the MIC, then taxpayers who self-construct property would be given a distinct advantage vis-à-vis taxpayers who purchase qualified property from a third party contractor. Staff does not believe that this result would be consistent with the legislative intent. Based upon the above discussion, staff will not be incorporating either of these proposed changes into the draft regulations.

#### Inclusion of Freight Costs

The letter specifically requests that freight and transportation charges that are not separately stated and that are thus subject to California sales and use tax should be treated as qualified costs under the regulations. Staff agrees with this proposed change, but only to the extent that the freight or transportation costs are properly chargeable to capital account, are directly related to the qualified property, and are subject to California sales or use tax. As limited by the foregoing sentence, staff will incorporate your proposal into the next draft of the proposed regulations.

#### Capitalization Requirement - “Chargeable” versus “Charged”

The letter specifically requests that the requirement that costs must be included in a taxpayer’s basis for depreciation in order to be treated as qualified costs be deleted since you believe that this requirement “exceeds the statutory requirement in CRTC Section 23649(b)(1)(C).” It then suggests that revisions to the capitalization requirement in the draft proposed regulations.

CRTC Section 23649(b)(1)(C) uses the phrase “properly chargeable to the capital account of the qualified taxpayer.” Staff believes that this phrase was inserted into the definition of qualified costs by the Legislature in order to prevent taxpayers from obtaining both an immediate deduction of an item and a MIC on the same amount. IRC Section 179(a) specifically states that “[a] taxpayer may elect to treat the cost of any Section 179 property as an expense which not chargeable to capital account.”

Thus, if a personal income taxpayer makes an IRC Section 179 election for an item of property which would otherwise qualify for the MIC, staff believes that the taxpayer could not claim the MIC on that item of property since the amount of the IRC Section 179 deduction would not be an amount properly chargeable to the capital account of the qualified taxpayer. It should be noted that California does not conform to IRC Section 179 under the Corporate Tax Law (except as to S corporations), so corporate taxpayers would generally not be affected by this limitation in the proposed regulations.

However, corporate taxpayers who wish to claim the MIC with respect to qualified property for which an enterprise zone deduction, program area deduction, or LARZ business expense deduction, must reduce the qualified cost under the MIC of each such item of property by the amount allowed to be expensed under these provisions. Based upon the above discussion, staff will not be incorporating this proposed change into the draft proposed regulations.

#### Definition of “Placed in Service”

The letter specifically requests that the requirement that property be “placed in service,” as defined in the draft regulations, prior to claiming the MIC be deleted because it is believed that the statute does not support the limitation. Instead, the letter views the “placed in service” limitation as only a “geographical” limitation, rather than a “timing” (or tax accounting) limitation.

Staff believes that the language of CRTC Section 23649(d)(1), which sets forth the elements of the “qualified property” definition, specifically requires that property be “placed in service” in a “tax accounting” sense prior to the taxpayer claiming the MIC. The specific language that staff believes supports this interpretation is that property “is primarily used for any of the following: (A) For the manufacturing, processing, ....” Prior to the time property is actually placed in service, the taxpayer cannot “primarily use” the property in one of the specified qualified activities, and thus the property would not be qualified property within the meaning of CRTC Sections 23649(a) and (d).

In addition, unlike the old federal IRC, which had specific provisions under which a taxpayer could elect to claim a credit prior to the place in service date if the taxpayer had “qualified progress expenditures,” the MIC has no similar statutory provisions which would permit a taxpayer to claim the MIC prior to the placed in service date. As a result, staff will not be incorporating this proposed change into the revised draft of the proposed regulations.

#### Recapture Rules - “Disposition” Definition

The letter specifically request that the portion of the recapture rules relating to when use of property in a non-qualified activity will constitute a “disposition” need to be changed to clarify that only when the subject property is “primarily” used in a non-qualified activity will a disposition be deemed to occur. Staff agrees with your suggested change and will incorporate it into the revised draft of the proposed regulations.

#### “Lump-Sum” or “Fixed-Price” Contracts - Evidence of Sales Tax Payment

The letter specifically requests that taxpayers be able to use alternative methods to satisfy the requirement that they establish that California sales or use tax was paid in the context of a lump sum or turnkey contract. The letter also suggests that bids or similar time and materials contract could be used to substantiate the amount of sales tax paid for purposes of the MIC.

Staff is sympathetic to the recordkeeping difficulties raised by this request, and is generally willing to permit taxpayers to establish that California sales or use tax was paid under a lump sum or turn key contract by using bids, similar contracts, or perhaps affidavits from the contractor. However, staff emphasizes that even with this change, a taxpayer will still need to obtain the cost breakdowns under the contract in order to establish (a) the amount of qualified property (as opposed to non-qualified property) that is the subject of the lump sum or turn key contract, (b) the amount of qualified property on which California sales or use tax was paid, (c) the amount of direct capitalized labor costs allocable to qualified property, and (d) the amount of non-qualified costs (such as contract profit, which is not properly treated as capitalized labor), if any, under the contract.

Staff will attempt to incorporate your suggested change on the recordkeeping portion of your request into the next draft of the proposed regulations, most likely in the form of revised examples, but cautions you regarding the other items outlined in this response.

#### Definition of “Pollution Control”

The letter specifically requests that the definition of pollution control be revised to include the abatement or control of pollution of land. Staff agrees in principle with your suggested change to the definition of pollution control, and will consider incorporating them into the revised draft proposed regulations.

Another letter specifically requests that the definition of pollution control be modified to clarify that a “reduction” of pollution or other contaminants will qualify. Staff agrees in principle with your suggested change with respect to the reduction of pollution, and will consider incorporating this into the revised draft regulations.

The letter also states that the regulations should make it clear that the “standards” being referred to in the definition of pollution control are those of the local or regional governmental agency “having jurisdiction over the particular site where the project is located.” CRTC Section 23649(d)(1)(D) states that one of the qualified activities for the qualified property determination is “[f]or pollution control that meets or exceeds standards established by the state or by any local or regional governmental agency within this state.” Staff believes that the reference to “within this state” was specifically intended by the Legislature to mean only those governmental agencies that are located in California.

Your suggested change implies that any qualified cost incurred solely by reason of pollution control standards established by a federal or multistate governmental agency having jurisdiction over the taxpayer’s activities in California would be included in the determination of qualified pollution control property.

Staff believes that the reference to “within this state” modifies the phrase “governmental agency” and therefore any federal or multistate governmental agency’s standards should not be considered for the MIC pollution control qualified activity determination under CRTC Section 23649(d)(1)(D). Your suggested change would broaden the definition of pollution control beyond that which the statute authorizes. Thus, staff will not incorporate this suggested change into the next draft of the regulations.

#### Ordering of Credits

The letter requested that the order in which credit carryovers may be applied against tax liability be addressed in the regulations. Staff understands that, since the MIC has a carryover limited to eight or ten years, it is in the interest of taxpayer that MIC carryover be applied before carryovers that do not have time constraints. Since future tax credits may be enacted with carryovers that are limited in duration, this issue will be addressed in a separate regulatory project covering all credit carryovers.

#### Finance Leases vs. Operating Leases

The letter specifically requests that certain changes be made in the draft proposed regulations regarding the determination of whether a lease is an operating lease or a finance lease under

California sales and use tax law. First, you state that a lease with a “must purchase” clause is treated as a finance lease under California sales and use tax law (CRTC Section 6006.3 and Regulation 1660(a)(2)). Second, you state that a lease may also be treated as a finance lease under California sales and use tax law using the “facts and circumstances” test under Regulation 1641(b). Finally, you suggest inclusion of a disclaimer phrase regarding any discussion in the proposed regulations of California sales and use tax law.

With respect to your first comment regarding “must purchase” clause leases, staff consulted with staff at the SBE. SBE staff indicated that they were unclear as to how this comment would apply in this situation. In addition, staff notes that if California sales or use tax is due on the entire purchase price upon commencement of the lease (and no resale certificate could be delivered since the transaction is per se treated as a sale for California sales and use tax purposes), then the lease will probably be treated as a “finance lease” for California sales and use tax purposes. As a result, staff will not be incorporating this first suggested change into the revised draft of the proposed regulations.

With respect to your second comment regarding a “facts and circumstances” test, staff again consulted with SBE staff on this situation and SBE staff again indicated that they were unclear as to how this comment would apply in this situation. Staff again notes that, if California sales or use tax is due on the entire purchase price upon commencement of the lease (and no resale certificate could be delivered since the transaction is per se treated as a sale for California sales and use tax purposes), then the lease will probably be treated as a “finance lease” for California sales and use tax purposes. As a result, staff will not be incorporating this second suggested change into the revised draft of the proposed regulations.

Staff particularly appreciates your final suggestion that a disclaimer phrase be included regarding the California sales and use tax discussion in the proposed regulations, and will include a disclaimer phrase in the revised draft of the proposed regulations to make it clear that the MIC regulations are not controlling for California sales and use tax law purposes and that such references are either to the MIC statutes or are for illustrative purposes only.

#### Delivery of Resale Certificate

The letter specifically requests that Example 1 of proposed Regulation 23649-6(b)(4)(D) be revised since under current California sales and use tax law, it appears that H in the example would not be entitled to deliver a resale certificate to G upon H’s acquisition of the leased property.

Staff consulted with staff at the SBE to confirm the result under California sales and use tax law, and staff agrees that the example as written does not accurately reflect current California sales and use tax law. As a result, staff will be modifying the example in the revised draft of the proposed regulations to reflect your comment and the correct result under California sales and use tax law.

#### Acquisition Sale-Leaseback

The letter specifically requests that an acquisition sale-leaseback not be treated as a “disposition” under the recapture rules. However, staff notes that, under traditional federal and California income tax analysis, an acquisition sale-leaseback results in a “shift” or transfer of the income

tax ownership of the property. As a result, the user-lessee has “disposed” of the qualified property for purposes of the MIC and recapture of the MIC is required.

With respect to the next logical question of whether the lessor-purchaser in the sale-leaseback transaction will be treated under the MIC as having “qualified cost” upon which the lessee-user can claim the MIC, staff notes that the lessor-purchaser in a sale-leaseback is not paying California sales or use tax on their acquisition and thus has not satisfied the requirement that California sales or use tax be paid.

In addition, staff does not believe that the requirement that California sales or use tax be paid can be treated as having been “indirectly” satisfied in this situation based upon the language in CRTC Section 23649(b)(1)(B), since staff believes that the “indirect” payment language only applies to situations where an agency or similar relationships exists between the actual payor of the tax and the qualified taxpayer (most likely in a contractor situation).

Finally, while staff is aware that the old federal ITC contained a rule similar to your suggestion whereby property eligible for the credit would not be treated as having been placed in service if a sale-leaseback transaction occurred within 90 days of the first functional use of the property, staff does not believe that this conclusion can be reached for MIC purposes in the absence of a legislative clarification.

As you are aware, the old federal rule was a specific statutory rule. While staff does not believe that the result you have urged should be per se discouraged or precluded as a matter of California tax policy, staff simply does not believe that it can administratively provide a rule that would disregard the placed in service rules generally applicable solely for purposes of the MIC, not income tax ownership rules applicable to leasing transactions. Staff is also disinclined to administratively provide such a rule for purposes of the MIC where the same rule would not be applicable for other California income or franchise tax purposes. As a result, staff will not be incorporating this suggested change into the proposed regulations.

#### Transfer of Title to Property as a Security Interest

The letter specifically requests that an exception to the “disposition” rules of Regulation 23649-8(b) be provided in the case where a qualified taxpayer transfer nominal legal title to qualified property to a “finance lessor” in the form of a security interest. In the transaction that you have described, you have assumed that there would be no shift of the tax ownership of the qualified property for federal or California income tax purposes since the transaction would be treated as a “finance lease” for such purposes, with the transferor-user of the qualified property continuing to be treated as the tax owner of the property following the transfer (with the result that the “lessor” would not be entitled to claim depreciation for federal or California income tax purposes).

As a result, you suggest that this transfer should not be treated as a “disposition,” and should not trigger a recapture of any MIC previously claimed by the transferor-user with respect to the qualified property. Staff agrees that in this limited factual situation when a transfer for the sole purpose of creating a security interest occurs, with no shift in the income tax ownership or use of the qualified property from the qualified taxpayer who originally claimed the MIC, then no recapture of the previously claimed MIC should be triggered.

Staff notes that this conclusion is consistent with the result in Rev. Rul. 72-543, 1972-2 C.B. 87, wherein the IRS ruled that a financing arrangement was not to be treated as a “sale-leaseback” for investment tax credit purposes. Staff will incorporate this exception into the revised version of the draft proposed regulations.

#### Definition of “Recycling”

The letter specifically requests that certain additional language be added to the definition of the term “recycling.” We agree in principle that the definition in draft proposed regulation 23649-2(o) uses certain words and phrases that would benefit from further definition. We also agree that the reuse of manufacturing waste and the reduction, avoidance, or elimination of the generation of hazardous waste is consistent with the type of recycling associated with manufacturing. Thus, we will generally incorporate the additional language you suggest in your letter into the revised draft proposed regulations.

#### Definition of “Research and Development”

The letter specifically requests that the second and third sentences of the proposed definition of “research and development” be deleted from the draft regulation since “it is unclear what this adds...” The MIC’s statutory definition of “research and development” specifies that the term means “those activities that are described in Section 174 of the IRC or in any regulations hereunder.” These two sentences appear in Treasury Regulation Section 1.174-2(a)(1), and staff believes that these two sentences further describe the types of research and development “activities” that qualify for the MIC. As a result, staff intends to leave these two sentences in the draft regulations.

#### Qualified Taxpayer - SIC Code Classification

The letter specifically requests that a number of changes with respect to the portion of the draft regulations relating to the determination of who is a qualified taxpayer. First, you requested that the word “Thus:” in the second sentence under Regulation 23649-3(b) be deleted, and that the second word in that sentence, “if,” be capitalized as the initial word in that sentence. Staff agrees with this suggested change, and will incorporate it into the revised draft regulations.

Your second specific request was to insert a new third sentence under Regulation 23649-3(b) before the current fourth sentence. In this case, the current second sentence indicates that in order to be a qualified taxpayer, a taxpayer need be engaged in “at least one” qualifying line of business. Your suggested change would simply clarify that a taxpayer engaged in more than one line of business, all of which qualify under Division D of the SIC Manual, would also be a qualified taxpayer. Staff believes this is probably clear from the existing language, but staff will endeavor to modify the second sentence by, for example, replacing the “at least one” phrase with a phrase such as “one or more” in order to remove any doubt that may exist.

Finally, your last request under this portion of the regulation is to delete Regulation 23649-3(b)(1) through -3(b)(5) because “this is confusing and unnecessary.” Staff is uncertain as to what in particular is “confusing” since your comments do not provide any specific examples, so that staff is unable to address this particular aspect of your comment.

However, with respect to your comment that this portion of the regulation is “unnecessary,” staff is unable to agree. That portion of the regulations provides the specific rules that apply in



determining whether a taxpayer is “engaged in those lines of business described in Codes 2000 to 3999, inclusive, of the SIC Manual,” and is thus a qualified taxpayer for purposes of the MIC.

Furthermore, as you may be aware, the FTB directed staff, in its drafting of the proposed regulations, to ensure that they were, to the extent possible, consistent with the SBE’s Regulation 1525.2 (relating to the sales tax exemption for manufacturing equipment). The referenced portions of the draft regulations are very similar to SBE Regulation 1525.2(c)(5)(B), except that the proposed MIC regulation contains examples designed to illustrate the concepts discussed in the text of this portion of the regulations. Based upon the above discussion, staff will not be incorporating this third proposed change into the draft proposed regulations.

#### Qualified Property - Tangible Personal Property

The letter specifically requests that the phrase “and R&D” be inserted into the definition of “tangible personal property” in the draft regulation. Staff originally lifted this definition directly out of Treasury Regulation Section 1.48-1(c) (eighth sentence), modifying it to eliminate certain types of property that would not qualify because they could never be used in a qualifying activity.

For this reason, staff would prefer not to make this change since “research and development equipment” is not a specifically descriptive term used to describe a particular “type” of property like a printing press or production machinery. However, staff can assure you that it is clear that types of property used in R&D that satisfy each of the four requirements necessary for property to be treated as qualified property will qualify for the MIC (assuming the other MIC requirements are satisfied).

#### Special Purpose Buildings

The letter specifically requests that the phrase “that portion of” be deleted from the first sentence of Regulation 23649-5(c)(1). Staff had originally included this phrase to confirm that a portion of a building, as well as an entire building, could qualify as a special purpose building for purposes of the MIC. In order to clarify your concern, staff will change the first sentence in the proposed regulation to read as follows: “For purposes of this section, the term “special purpose building and foundation” shall mean an entire building, or that portion of any building....”

#### Recordkeeping Requirements

The letter specifically requests that the portion of the regulations relating to recordkeeping requirements applicable to the MIC should be deleted in its entirety because the language may suggest that “normal books and records may not be adequate.” Staff understands your concern, and certainly did not intend to create the inference that “normal books and records may not be adequate” with respect to the MIC. However, you should be aware that other commentators on the proposed regulations have requested that this portion of the proposed regulations not only be retained, but also further expanded.

In fact, staff’s intent in this portion of the proposed regulations was to indicate the minimum documentation staff believes a taxpayer should maintain to substantiate a claimed MIC, but not have the regulation become so detailed as to establish a new recordkeeping system. At the current time, staff is intending to generally retain this section, although staff will endeavor to clarify in the Statement of Reasons that accompany the formal noticing of the regulations that



this section is not designed to create any inference that “normal books and records may not be adequate.” Staff will be happy to continue working with you on this issue to attempt to fully resolve your concerns.

#### Qualification of Used Property Moved into California

The letter specifically requests that the regulations deal with the issue of whether moving “used” property into California can qualify for the MIC. Staff agrees that the question of whether “used” property can qualify for the MIC should be addressed in the proposed regulations, and will attempt to clarify this issue in the next draft.

However, staff also notes that the specific question you raise – whether a qualified taxpayer can place property in service outside California and thereafter “move” such property into California, and then claim the MIC on such property – presents a perhaps difference problem than you address in your letter. The key issue in such a “movement of property into California” situation is undoubtedly going to be whether the qualified taxpayer has paid California sales or use tax with respect to the otherwise qualified property.

Staff will be happy to include either language or examples addressing the “movement of property in California,” although any such language or examples will need to contain assumptions that the payment of California sales or use tax limitation has been satisfied, or that if it has not been satisfied, that the costs of the property in question will not be qualified costs for purposes of the MIC.

#### Definition of “Primarily”

The letter specifically requests that in the case of “dual-use” property, the regulations provide more flexibility in applying the “primarily” standard found in the MIC statute. In particular, you address the issue of “actual” use versus “intended” use, and you suggest that in some factual patterns involving expansion of start-up businesses, application of the “actual” use test in the current version of the draft proposed regulations may result in some items of property not qualifying for the MIC due to incidental use during the property’s first year.

While staff is generally in agreement that some potentially unintended results may obtain in particular factual situations, staff believes that any fix should be legislative, rather than administrative. In addition, staff believes that the relatively short recapture period (only one year) further mitigates against providing a particularly generous rule in this particular situation. However, staff will modify the revised draft to clarify that the 12-month use test will be applied over the 12-month period following the placed in service date, rather than using an income or taxable year measuring standard.

#### Lease Purchase Option as a Binding Contract

The letter specifically requests that the regulations be modified to provide that the binding contract rules will not treat an option to purchase under a lease as a binding contract in situations where there is a negotiation of the option price after January 1, 1994. Staff is uncertain as to why such a rule would be required in the proposed regulations.

If a lessee under an operating lease exercises an option to purchase the leased property after January 1, 1994, and pays California sales or use tax upon exercise of the option, then the

amount upon which California sales or use tax was paid would generally qualify for the MIC. However, if some portion of the option price were actually paid prior to January 1, 1994 (perhaps in the form of a deposit or a credit certain lease payments to the option price), then that portion would not qualify under the binding contract rules. In any event, the binding contract rules only operate to disallow as qualified costs for MIC purposes any amounts actually paid prior to January 1, 1994, under a contract that was binding on such date.

#### Timing of Credit Where Sales Tax Paid in Prior Accounting Period

The letter specifically requests that the regulations discuss the “timing” of the MIC in a situation where the lessor’s payment of California sales tax occurs in a period that is different than the lessee’s taxable year. At our follow-up meeting, you indicated your concern was solely one of “timing” where the actual remittance to the SBE does not occur until after the income or taxable year in which the lessee is actually using the qualified property.

Staff agrees with your concern and will provide language in the revised draft of the proposed regulations specifying generally that the requirement that California sales or use tax be paid prior to claiming the credit will be deemed satisfied at the time the obligation to remit the sales or use tax amount has become fixed under California sales and use tax law. Of course, if the California sales or use tax on the lessor’s purchase of the property is never collected by the retailer because the lessor delivered a resale certificate, then no MIC would be allowable to the lessee.

#### “Placed in Service” Requirement in Leasing Transactions

The letter specifically requests that the “placed in service” rules be clarified in the context of leasing transactions to make the MIC allowable on the date the lessee’s obligations under the lease commence (i.e., the “hell or high water date”). Staff generally agrees with this comment and will attempt to clarify this in the next draft of the proposed regulations, but notes that the “qualified property” rules require actual use of the property as a prerequisite for property to be treated as “qualified property” for purposes of the MIC (so that the MIC will not be available to the lessee until the lessee actually begins using the qualified property in a qualified activity).

#### Transitional Election for Certain Leases - Recordkeeping

The letter specifically requests that staff set forth rules as to how the transitional election for certain leases will be audited and enforced. As of the date of this letter, audit staff is working closely with the staff of the SBE to resolve overlap and other audit issues created under the MIC and the manufacturers’ partial sales and use tax exemption. Staff believes that it is unlikely that your suggestions regarding audit policy would be incorporated into the proposed regulation.

#### Timing of Lessor’s Report to Lessee

The letter specifically requests that the issue of the timing of the lessor’s report may need to be addressed in light of your earlier comments. Staff will incorporate language into the next draft of the proposed regulations to address your concern as to the lessor’s ability to provide the necessary statement where the “timing” of the actual payment of the California sales or use tax does not occur prior to the date the lessor is required to deliver this statement.

#### “Qualified Costs”

The letter specifically requests that, in a case where a contractor is paying California sales or use tax on the materials used to construct qualified property on behalf of a qualified taxpayer, that the qualified taxpayer should be entitled to rely upon a written representation from the contractor that the sales tax was paid.

Staff generally is receptive to providing such a rule; however, even with such a rule, staff notes that a qualified taxpayer would NOT be relieved of its obligation to substantiate the specific qualified cost and qualified property elements of the contract. Staff will attempt to incorporate your suggested language or some similar language into the recordkeeping portion of the revised draft regulations.

Another letter specifically requests that a qualified taxpayer be permitted to use contracts and certain related documentation in order to establish the “amount” of California sales tax paid under a construction contract. Staff believes that a taxpayer has the burden of substantiating the amount of qualified costs eligible for the MIC.

While in certain limited circumstances the approach suggested in your letter may represent an appropriate methodology to establish the amount of qualified costs under a construction contract, such as when no other records existed or could reasonably be obtained by the qualified taxpayer, staff is extremely reluctant to provide such a rule in the proposed regulations that would apply to all cases since original records, rather than approximations, are always preferable in substantiating claimed credits. Ultimately, this is probably more of an audit issue that would be appropriately resolved with FTB auditors on a case-by-case basis.

#### Sale-Leaseback Within 90 Days of Placed in Service Date

The letter specifically requests that, in a situation where a qualified taxpayer acquires qualified property and pays California sales tax and then, within 90 days of placing such property in service sells the property to a third party and then leases it back, the MIC should not be recaptured. You suggest that, since the lessee has paid California sales tax upon their acquisition of the qualified property, the sale-leaseback transaction should, in effect, be disregarded during a limited window period. Staff assumes that the 90-day suggestion is derived from prior federal law, former IRC Section 48(b)(2).

While staff is aware that the hold federal IRC statute contained a rule similar to your suggestion whereby property eligible for the credit would not be treated as having been placed in service if a sale-leaseback transaction occurred within 90 days of the first functional use of the property, staff does not believe that this conclusion can be reached for MIC purposes in the absence of a legislative clarification. As you are aware, the old federal rule was a specific statutory rule.

While staff does not believe that the result you have urged should be per se discouraged or precluded as a matter of California tax policy, staff simply does not believe that it can administratively provide a rule that would disregard the placed in service rules generally applicable solely for purposes of the MIC. Staff is also disinclined to administratively provide such a rule for purposes of the MIC where the same rule would not be applicable for other California income or franchise tax purposes. As a result, staff will not be incorporating this comment into the proposed regulations.

#### Qualified Cost to Lessor

The letter specifically requests that the draft proposed regulations be modified to clarify that the “qualified cost” to a lessor includes any amounts paid to the original transferor that are characterized as either sales or use tax reimbursement. In the case of a leasing transaction that is not treated as a “sale” under California sales tax law (CRTC Section 23649(f)(3)(A)(ii) generally provides that “the ‘qualified cost’ upon which the lessee shall compute the credit provided under this section shall be equal to the original cost to the lessor (within the meaning of Section 24912) of the qualified property that is the subject of the lease.”

However, CRTC Section 23649(f)(3)(A)(iii) provides an important limitation upon the lessor’s “qualified cost,” stating that “[f]or purposes of this subdivision and clause (iv), the amount of original cost to the lessor which may be taken into account under clause (ii) shall not exceed the purchase price upon which sales tax reimbursement or use tax has been paid under the preceding sentence or under clause (iv).” Staff believes that the purpose of this limitation language was to place leasing transactions on an equal footing with purchase transactions.

In the case of a non-lease purchase or other acquisition transaction involving qualified property, CRTC Section 23649(b)(1)(B) provides, in pertinent part, that qualified costs include “an amount upon which the qualified taxpayer has paid ... [California] sales or use tax ....” Staff believes that the statute is absolutely clear that the amount of “qualified costs” upon which the MIC is computed does not include the California sales or use tax paid since a taxpayer does not pay sales or use tax on such tax amounts. Based upon the above discussion, staff will not be incorporating your suggested change into the draft proposed regulation.

### **Explanation of Alternatives One and Two**

As required by Section 11346.4 of the Government Code, this is notice that a public hearing has been scheduled to be held at 10am on February 13, 1996 at 450 N Street, Room 121, Sacramento, California, to consider the adoption of one of two alternative sets of Sections 17053.49-0 through 17053.49-11 (relating to the Personal Income Tax Law) and Sections 23649-0 through 23649-11 (relating to the Bank and Corporation Tax Law) in Title 18 of the California Code of Regulations. Revenue and Taxation Code Sections 17053.49 and 23649 (hereinafter collectively referred to as the “Manufacturers’ Investment Credit”) provide an income or franchise tax credit to qualified taxpayers for qualified costs paid or incurred for qualified property.

The proposed regulations under Sections 17053.49 and 23649 provide definitions, interpretations, and examples to aid taxpayers in determining qualification for the credit. At the time and place specified above, the FTB will consider two alternative sets of regulations, one entitled Alternative One and one entitled Alternative Two. The FTB will consider adoption of one of the alternatives, but will not adopt both.

Both alternatives include Sections 17053.49-0 through 17053.49-11 and Sections 23649-0 through 23649-11. Alternative One is described in detail in a separate notice accompanying this notice.

This notice refers to Alternative Two, which is identical to Alternative One, with the exception of Sections 17053.49-5 and 23649-5, relating to qualified property for the MIC. Alternative One, described in a separate notice, includes the proposed adoption of Sections 17053.49-5 and 23649-5 without specific provisions regarding the inclusion of property used to refine

“reformulated” or “oxygenated” gasoline in the definition of “qualified property” for purposes of the MIC.

Alternative Two includes the proposed adoption of Sections 17053.49-5 and 23649-5 with specific language which separately states that property used to refine certain petroleum-based products, referred to as “reformulated” or “oxygenated” gasoline, may be treated as qualified property.

The hearing will be conducted by the three-member FTB. Interested persons are invited to present comments, written or oral, concerning the proposed regulatory action. It is requested, but not required, that persons who make oral comments at the hearing also submit a written copy of their comments at the hearing.

#### Written Comment Period

Written comments or oral arguments will be considered by the FTB before adopting these regulations if received prior to the conclusion of the hearing scheduled for February 13, 1996. All relevant matters presented will be considered before the proposed regulatory action is taken. Written comments should be submitted to the agency officer named below.

#### Authority & Reference

Section 19503 of the Revenue and Taxation Code authorizes the FTB to prescribe regulations necessary for the enforcement of Part 10 (commencing with Section 17001), Part 10.2 (commencing with Section 18401), Part 10.7 (commencing with Section 21001), and Part 11 (commencing with Section 23011) of the CRTC. The proposed regulatory action interprets, defines, implements, and makes specific Sections 17053.49 and 23649 of the CRTC.

#### Informative Digest/Plain English Overview

SB 671 (Stats. 1993, Ch. 881) added an entirely new section to both the PITL and the BCL. These sections generally provide a six percent (6%) income or franchise tax credit to qualified taxpayers for qualified costs for qualified property that is placed in service in California. The MIC is generally available to taxpayers engaged in manufacturing and certain other qualified activities.

SB 676 (Stats. 1994, Ch. 751) amended these two sections by expanding the definition of qualified property to include “off-the-shelf” computer software and excluded from credit eligibility any amounts actually paid or incurred under contracts that were binding on or before January 1, 1994. SB 676 also extended the MIC to include certain property leased by a qualified taxpayer for use in a qualified activity and made numerous other technical changes to these two sections.

Sections 17053.49 and 23649 are new California tax incentive provisions designed generally to encourage the growth and expansion of manufacturing activities and jobs within California. While there is no current federal law that is directly comparable to the MIC, former federal law contained a similar investment tax credit incentive provision in prior law Internal Revenue Code Sections 38 and 46 through 48, and the regulations there under. Certain concepts and relevant definitions contained in these proposed regulations have been drawn from that prior federal investment tax credit law.



Regulations 17053.49-0 through 17053.49-11 and 23649-0 through 23649-11 are needed because of the relative complexity of Sections 17053.49 and 23649 and the use of terms of art, many of which are not defined in the statutes. By defining and explaining these terms of art, and providing examples to illustrate these definitions and explanations, these regulations provide interpretations to assist interested parties in easily determining eligibility for and the amounts of the MIC. In drafting these regulations, the FTB looked to Sections 17053.49 and 23649, the legislative history, existing federal and state tax provisions, and the SBE's Regulation 1525.2

In addition, the FTB held a symposium on January 17, 1995, wherein questions were asked and issued were presented, and prior to and following which FTB staff received written comments from affected members of the public. The symposium and written comments aided FTB staff in determining the various areas in the statutes that needed to be addressed by the regulations. On June 9, 1995, FTB staff sent to interested parties an informal draft of proposed regulations for public input and comment. Nine written comments were received in response to this informal draft, further aiding FTB staff in determining the various areas in need of further clarification.

#### Alternative Two, Regulations 17053.49-0 through 17053.49-11

These regulations are organized as a series of related regulations that are separated by subject matter area. Where appropriate or required, specific cross-reference information has been provided in the text of the applicable regulations. Moreover, due to the complexity and length of both the statute and these regulations, Regulation 17053.49-0 contains a non-substantive, non-binding table of contents designed to assist readers in locating specific subject matter areas in Regulations 17053.49-1 through 17053.49-11.

Alternative Two, Regulations 17053.49-1 provides rules regarding the amount of the MIC, the first year in which the MIC may be claimed, cross-reference information and general reference information regarding these regulations.

Alternative Two, Regulation 17053.49-2 provides general definitions for certain words and phrases used in Section 17053.49 and Regulations 17053.49-1 through 17053.49-11. Specifically, definitions of "biopharmaceutical activities," "biotech," "capitalized labor," "fabricating," "gross receipts," "manufacturing," "net assets," "packaging," "placed in service," "pollution control," "primarily," "process," "processing," "qualified activity," "recycling," "refining," "research and development," "SIC Codes," "SIC Manual," "small business," and "total MIC" are provided.

Alternative Two, Regulation 17053.49-3 provides rules and examples for determining who is a qualified taxpayer for purposes of the MIC. Section 17053.49 requires that a taxpayer be engaged in a line of business described in SIC Codes 2000 through 3999, inclusive, of the SIC Manual, 1987 edition. This regulation describes how to classify business activities using the SIC Manual's "establishment" method, including rules for distinguishing between operating establishments and auxiliary establishments, rules for determining when employment is significant, including a regulatory safe harbor, and rules for making non-qualified activity SIC Code assignments.

Alternative Two, Regulation 17053.49-4 provides rules and examples for determining what costs may be considered qualified costs for purposes of the MIC. Specifically provided are rules regarding the requirements that California sales or use tax be paid and that costs be chargeable to

capital account. Also included are rules regarding which capitalized labor costs are treated as directly allocable costs and are thus eligible for the MIC, and binding contract rules (including successor or replacement contracts, option contracts, and conditional contracts) specifying how costs actually paid prior to January 1, 1994 are treated.

Alternative Two, Regulation 17053.49 is the only regulation under Alternative Two that is different than Alternative One. Alternative Two, Regulation provides rules and examples for determining what types of property may be treated as qualified property for purposes of the MIC. Specifically, this regulation described as Alternative Two, describes and illustrated the general requirements that qualified property be tangible personal property defined in IRC Section 1245(a)(3)(A).

Unlike Alternative One, this regulation provides an exception to the tangible personal property requirement for property that is exclusively used by a qualified taxpayer engaged in refining activities properly classified in SIC Code 2911 to produce “reformulated gasoline” or “oxygenated gasoline.” Under this exception, the described property may be qualified property even though defined in IRC Section 1245(a)(3)(B).

This regulation also explains that qualified property must be used in a line of business described in SIC Codes 2000 through 3999, inclusive, and be primarily used in a qualified activity. Also included are rules regarding special purpose buildings and foundations, the types of property that are specifically excluded from being qualified property, and rules regarding the movement of used property from another state or country into California.

Alternative Two, Regulation 17053.49-6 provides rules applicable to leases of qualified property. Specifically, this regulation describes and illustrates the statutory rules for distinguishing operating leases (leases not treated as sales for California sales and use tax purposes) from finance leases (leases treated as sales for California sales and use tax purposes), as well as the statutory requirements applicable to each type of lease. This regulation also contains rules regarding the amount of MIC a lessee may claim and certain lessor reporting requirements applicable to operating leases.

Alternative Two, Regulation 17053.49-7 provides rules relating to how the MIC is computed and allocated by certain pass-through entities, which include partnerships, S corporations, and estates and trusts. This regulation also specifies that the carryforward period is determined at the entity level when a pass-through entity is the qualified taxpayer.

Alternative Two, Regulation 17053.49-8 provides rules for recapturing a previously allowed MIC where a disposition has occurred within one year of the placed in service date. This regulation defines a disposition to include any removal of property from California, a sale or other disposition to an unrelated party (as defined in IRC Sections 267, 318 or 707), a conversion to a primarily non-qualified use, or an acquisition by a lessee of qualified property that is being leased by such lessee.

This regulation also provides rules regarding the applicable recapture periods, rules regarding the adjustment of carryforwards when a disposition occurs, recapture rules applicable to partners, shareholders or beneficiaries of pass-through entities who were allowed the MIC, and special rules for recapturing any MIC allowed in 1994, but deferred until 1995.



Alternative Two, Regulation 17053.49-9 provides rules for determining the length of the carryforward period for any MIC that is limited by other provisions of the CRTC, including the determination of whether the taxpayer is a “small business.” Additional rules are provided for determining the carryforward period for any MIC that is allowed in 1994, but deferred until 1995, and the rules for determining the carryforward period in the case of any MIC that is allowed to a pass-through entity.

Alternative Two, Regulation 17053.49-10 provides rules illustrating which books and records should be maintained to substantiate any MIC claimed. Specifically, this regulation discusses the general burden of proof, books and records that should be maintained, and the lessor’s reporting requirement in an operating lease transaction.

Alternative Two, Regulation 17053.49-11 provides miscellaneous rules applicable to the MIC. Specifically provided are the operative dates of the MIC, the interaction of the MIC with the LARZ credits, information on the election to claim a sales and use tax refund under CRTC Section 6902.2 in lieu of the MIC, and information on the sales and use tax exemption under CRTC Section 6377.

FTB staff has made every effort to minimize duplication and avoid conflicts with existing federal regulations. FTB staff is aware of no conflict with, nor duplication of, any existing federal regulations.

#### Disclosures Regarding the Proposed Regulatory Action

Mandate on local agencies and school districts: None

Cost or savings to any state agency: None

Cost to any local agency or school district which must be reimbursed under Part 7, commencing with Government Code Section 17500: None

Other non-discretionary cost or savings imposed upon local agencies: None

Cost or savings in federal funding to the state: None

Adverse economic impact on business including the ability of California businesses to compete with businesses in other states: Impacts in this area, if any, are the result of the statute and not the regulations per se. In making this determination, FTB staff has performed an analysis to comply with Government Code Sections 11346(a) and (b).

Cost to directly affected private persons/businesses potential: Impacts in this area, in any, are the result of the statute and not the regulations per se.

Significant effect on the creation or elimination of jobs in the state: Impacts in this area, if any, are the result of the statute and not the regulations per se.

Significant effect on the creation or new businesses or elimination of existing businesses within the state: Impacts in this area, if any, are the result of the statute and not the regulations per se.

Significant effect on the expansion of businesses currently doing business within the state: Impacts in this area, if any, are the result of the statute and not the regulations per se.

Effect on small business: The proposed regulations help small businesses to understand the current MIC and how they might benefit from it by interpreting and explaining the various provisions of the credit.

Significant effect on housing costs: None

Consideration of Alternatives:

In accordance with Government Code Section 11346.5(a)(1), the FTB must determine that no alternative considered by it would be more effective in carrying out the purpose for which the action is proposed or would be as effective and less burdensome to affected private persons than the proposed regulatory action.

Availability of Statement of Reasons and Text of Proposed Regulations:

An initial statement of reasons has been prepared setting forth the facts upon which the proposed regulatory action is based. The statement includes the specific purpose of the proposed regulatory action and the factual basis for determining that the proposed regulatory action is necessary.

The FTB has determined that it is not feasible to draft the text of the proposed regulations in plain English due to the technical nature of the regulations. However, a non-controlling plain English summary of the text of the proposed regulations, as well as the initial statement of reasons and all information upon which the proposed regulatory action is based, as well as the express terms of the proposed action, are available upon request from the agency officer named below.

Change or Modification of Actions:

The proposed regulatory action may be adopted by the three-member FTB after consideration of any comments received during the comment period.

The regulations may also be adopted with modifications if the changes are nonsubstantive or the resulting regulations are sufficiently related to the text made available to the public so that the public was adequately placed on notice that the regulations as modified could result from those originally proposed. The text of the regulations as modified will be made available to the public at least 15 days prior to the date on which the regulations are adopted. Requests for copies of any modified regulations should be sent to the attention of the agency officer named below.

**Initial Statement of Reasons**

Public Problem that the Regulations Are Intended to Address:

Sections 17053.49 and 23649 of the CRTC (collectively referred to herein as the “Manufacturers’ Investment Credit”) were first enacted by SB 671 (Stats. 1993, Ch. 881, effective January 1, 1994), and then substantially amended by SB 676 (Stats. 1994, Ch. 751, effective September 23, 1994). Sections 17053.49 and 23649 are virtually identical, except that Section 17053.49 relates to the Personal Income Tax, while Section 23649 relates to the Bank and Corporation Tax.

Currently there are no comparable federal statutes or regulations, although there was a federal investment tax credit (former Internal Revenue Code (IRC) Sections 38 and 46 through 48 and the regulations there under). Sections 17053.49 and 23649 are complex income and franchise tax credit statutes that contain many terms of art and undefined words and phrases, including specific references to the IRC and California sales and use tax sections of the CRTC.

The FTB has received numerous public requests for interpretation, clarification and guidance with respect to these sections. For example, taxpayers have requested clarification and guidance regarding the determination of who is a qualified taxpayer for purposes of the MIC. Taxpayers have also requested guidance with respect to determining what capitalized labor costs may be included in computing the MIC, what records must be kept, how the sales or use tax payment requirement should be documented, what types of property qualify, what types of leases qualify, and what specific rules apply to such leases, and the scope of certain definitions of the words and phrases used in Sections 17053.49 and 23649.

There are numerous other questions that taxpayers have raised orally with respect to specific interpretive issues under Sections 17053.49 and 23649. Because the FTB understands that many of these questions reflect areas of uncertainty or confusion, the FTB is proposing adoption of one of two alternative sets of regulations as a means to clarify as many of these questions as is possible.

#### Specific Purpose of the Regulations:

Section 19503 of the Revenue and Taxation Code authorizes the FTB to prescribe regulations necessary for the enforcement of Part 10 (commencing with Section 17001), Part 10.2 (commencing with Section 18401), Part 10.7 (commencing with Section 21001), and Part 11 (commencing with Section 23011) of the CRTC. The proposed regulatory action interprets, defines, implements, and makes specific Sections 17053.49 and 23649 of the CRTC.

The regulations clarify and interpret numerous provisions of the MIC statutes, CRTC Sections 17053.49 and 23649, by providing definitions of statutory words and phrases and by providing numerous hypothetical examples designed to illustrate the statutory and regulatory rules. This will aid taxpayers and the FTB to more efficiently determine eligibility for and the proper amounts to be claimed as credits under Sections 17053.49 and 23649. There is sufficient information in the proposed regulations to reduce taxpayer review of statutory references to other portions of the CRTC, the IRC, or Treasury Regulations.

#### Introduction and Background – SB 671 and SB 676:

SB 671 (Stats. 1993, Ch. 881) added an entirely new section to both the PITL and the BCL. These sections generally provide a six percent (6%) income or franchise tax credit to qualified taxpayers for qualified costs for qualified property that is placed in service in California. The MIC is generally available to taxpayers engaged in manufacturing and certain other qualified activities.

SB 676 (Stats. 1994, Ch. 751) amended these two sections by expanding the definition of qualified property to include “off-the-shelf” computer software and excluded from credit eligibility any amounts actually paid or incurred under contracts that were binding on or before January 1, 1994. SB 676 also extended the MIC to include certain property leased by a qualified

taxpayer for use in a qualified activity and made numerous other technical changes to these two sections.

Sections 17053.49 and 23649 are new California tax incentive provisions designed generally to encourage the growth and expansion of manufacturing activities and jobs within California. While there is no current federal law that is directly comparable to the MIC, former federal law contained a similar investment tax credit incentive provision in prior law Internal Revenue Code Sections 38 and 46 through 48, and the regulations there under. Certain concepts and relevant definitions contained in these proposed regulations have been drawn from that prior federal investment tax credit law.

Regulations 17053.49-0 through 17053.49-11 and 23649-0 through 23649-11 are needed because of the relative complexity of Sections 17053.49 and 23649 and the use of terms of art, many of which are not defined in the statutes. By defining and explaining these terms of art, and providing examples to illustrate these definitions and explanations, these regulations provide interpretations to assist interested parties in easily determining eligibility for and the amounts of the MIC. In drafting these regulations, the FTB looked to Sections 17053.49 and 23649, the legislative history, existing federal and state tax provisions, and the SBE's Regulation 1525.2

In addition, the FTB held a symposium on January 17, 1995, wherein questions were asked and issued were presented, and prior to and following which FTB staff received written comments from affected members of the public. The symposium and written comments aided FTB staff in determining the various areas in the statutes that needed to be addressed by the regulations. On June 9, 1995, FTB staff sent to interested parties an informal draft of proposed regulations for public input and comment. Nine written comments were received in response to this informal draft, further aiding FTB staff in determining the various areas in need of further clarification.

#### Regulations:

These regulations are organized as a series of related regulations that are separated by subject matter area. Where appropriate or required, specific cross-reference information has been provided in the text of the applicable regulations. Moreover, due to the complexity and length of both the statute and these regulations, Regulation 17053.49-0 contains a non-substantive, non-binding table of contents designed to assist readers in locating specific subject matter areas in Regulations 17053.49-1 through 17053.49-11.

The FTB has drafted two sets of regulations, Alternative One and Alternative Two of Sections 17053.49-0 through 17053.49-11. The two alternatives are identical, except for the qualified property provisions of Sections 17053.49-5 and 23649-5. These differences are discussed below in the discussion regarding Sections 17053.49-5 and 23649-5. Unless otherwise specified, all references to the Regulation Sections below refer to both Alternative One and Alternative Two.

Regulation 17053.49-1 provides rules regarding the amount of the MIC, the first year in which the MIC may be claimed, the appropriate year for fiscal year taxpayers to claim the MIC, cross-reference information and general reference information regarding these regulations. In addition, this regulation illustrates the statutory requirement that any MIC for costs paid or incurred in 1994 or in taxable years beginning in 1993 or 1994 may not be claimed until a qualified taxpayer's California tax return is filed for their first taxable year beginning on or after January 1, 1995.

Specifically, this regulation explains that the MIC for costs paid or incurred during 1994 shall be allowed as of the date the qualified property is placed in service, but deferred and claimed on the qualified taxpayer's return for its first taxable year beginning on or after January 1, 1995. The FTB felt that such clarification was required to prevent taxpayers from inadvertently attempting to claim the credit on a 1994 taxable year return or on an amended 1994 return.

Regulation 17053.49-2 provides general definitions for certain words and phrases used in Section 17053.49 and Regulations 17053.49-1 through 17053.49-11. Specifically, definitions of "biopharmaceutical activities," "biotech," "capitalized labor," "fabricating," "gross receipts," "manufacturing," "net assets," "packaging," "placed in service," "pollution control," "primarily," "process," "processing," "qualified activity," "recycling," "refining," "research and development," "SIC Codes," "SIC Manual," "small business," and "total MIC" are provided.

Where appropriate or specifically required by the statutory language of Section 17053.49, some of these definitions are further clarified by reference to existing California or federal law. For example, Section 17053.49 requires that, in order for capitalized labor costs to be treated as qualified costs, they must be "...directly allocable to the construction or modification..." of qualified property. Thus, this regulation defines "capitalized labor costs directly allocable to the construction or modification" of qualified property as those costs that are treated as direct (as contrasted with indirect) labor costs under the uniform capitalization rules set forth in IRC Section 263A and Treasury Regulation Section 1.263A-1.

Regulation 17053.49-3 provides rules and examples for determining who is a qualified taxpayer for purposes of the MIC. Section 17053.49 requires that a taxpayer be "engaged in a line of business described in SIC Codes 2000 through 3999, inclusive, of the SIC Manual, 1987 edition." This regulation describes how to classify business activities using the SIC Manual's "establishment" method, including rules for distinguishing between operating establishments and auxiliary establishments, rules for determining when employment is significant, including a regulatory safe harbor, and rules for making non-qualified activity SIC Code assignments.

However, since the SIC Manual uses an "establishment" concept to classify business activities, rather than a "line of business" approach, the FTB has clarified in this regulation that taxpayers should generally follow the SIC Manual classification approach to ascertain whether the taxpayer will be treated as a "qualified taxpayer" for purposes of the MIC. Examples are also provided to illustrate the application of the classification of business activities concept contained in the SIC Manual.

Regulation 17053.49-4 provides rules and examples for determining what costs may be considered qualified costs for purposes of the MIC. Specifically provided are rules regarding the requirements that California sales or use tax be paid and that costs be chargeable to capital account. Also included are rules regarding which capitalized labor costs are treated as directly allocable costs and are thus eligible for the MIC, and binding contract rules (including successor or replacement contracts, option contracts, and conditional contracts) specifying how costs actually paid prior to January 1, 1994 are treated.

Moreover, since qualified costs include only costs paid or incurred for qualified property on or after January 1, 1994, the regulation provides guidance for how costs actually paid before and after January 1, 1994, pursuant to a binding contract, successor or replacement contract, option contract and conditional contract, should be allocated for purposes of the MIC.



Alternative One and Alternative Two, Regulation 17053.49-5, provide rules and examples for determining what types of property may be treated as qualified property for purposes of the MIC. Alternative One and Alternative Two, Regulation 17053.49-5, are the only Sections that are different with respect to the two alternative sets of Regulations. This alternative Regulation 17053.49-5 provides rules and examples for determining what types of property may be treated as qualified property for purposes of the MIC. Specifically, this Sections describes and illustrates the general requirement that qualified property be tangible personal property defined in IRC Section 1245(a)(3)(A).

Alternative Two further defines qualified property to include additional refinery property that is not specifically included in Alternative One. This is the only substantive difference between Alternative One and Alternative Two. With respect to the requirement that qualified property only includes “tangible personal property defined in IRC Section 1245(a),” this alternative regulation section specifically defines the terms by reference to IRC Section 1245(a), the federal regulations under that section, and the old federal investment tax credit rules (which are specifically cross-referenced by Treasury Regulation section 1.1245-3(b) to supply the definition of “tangible personal property” under IRC section 1245(a) and implement what has been described as legislative intent with respect to specific refinery property.

This regulation section also explains that qualified property must be used in a line of business described in SIC Codes 2000 through 3999, inclusive, and be primarily used in a qualified activity. Also included are rules regarding special purpose buildings and foundations, the types of property that are specifically excluded from being qualified property, and rules regarding the movement of used property from another state or country into California.

Regulation 17053.49-6 provides rules applicable to leases of qualified property. Specifically, this regulation describes and illustrates the statutory rules for distinguishing operating leases (leases not treated as sales for California sales and use tax purposes) from finance leases (leases treated as sales for California sales and use tax purposes), as well as the statutory requirements applicable to each type of lease. This regulation also contains rules regarding the amount of MIC a lessee may claim and certain lessor reporting requirements applicable to operating leases. Finally, this regulation clarifies who must pay the California sales or use tax in order for the lessee in a leasing transaction to claim the MIC.

Regulation 17053.49-7 provides rules relating to how the MIC is computed and allocated by certain pass-through entities, which include partnerships, S corporations, and estates and trusts. This regulation also specifies that the carryforward period is determined at the entity level when a pass-through entity is the qualified taxpayer. This regulation applies well-established California income tax principles to clarify that the qualified taxpayer determination is to be made at the pass-through entity level (whether a partnership, S corporation, or estate or trust is involved), thereby allowing the MIC to be passed through to the partners, shareholders, or beneficiaries who might not directly satisfy the “qualified taxpayer” requirement.

Finally, this regulation illustrates the current California law whereby an S corporation may claim one-third of the MIC for purposes of the entity-level tax imposed on S corporations by Chapter 4.5 of Part 11 of the CRTC and pass-through 100% of the MIC without reduction for any amount utilized at the entity-level, to its shareholders.

Regulation 17053.49-8 provides rules for recapturing a previously allowed MIC where a disposition has occurred within one year of the placed in service date. This regulation defines a disposition to include any removal of property from California, a sale or other disposition to an unrelated party (as defined in IRC Sections 267, 318 or 707), a conversion to a primarily non-qualified use, or an acquisition by a lessee of qualified property that is being leased by such lessee.

This regulation also provides rules regarding the applicable recapture periods, rules regarding the adjustment of carryforwards when a disposition occurs, recapture rules applicable to partners, shareholders or beneficiaries of pass-through entities who were allowed the MIC, and special rules for recapturing any MIC allowed in 1994, but deferred until 1995.

Regulation 17053.49-9 provides rules for determining the length of the carryforward period for any MIC that is limited by other provisions of the CRTC, including the determination of whether the taxpayer is a “small business.” Additional rules are provided for determining the carryforward period for any MIC that is allowed in 1994, but deferred until 1995, and the rules for determining the carryforward period in the case of any MIC that is allowed to a pass-through entity.

Finally, this regulation specifies that the “small business” determination is to be made as of the last day of the qualified taxpayer’s taxable year in which the MIC is allowed, rather than claimed (in the case of 1994 qualified costs), or utilized (in the case of carryforward amounts).

Regulation 17053.49-10 provides rules illustrating which books and records should be maintained to substantiate any MIC claimed. Specifically, this regulation discusses the general burden of proof, books and records that should be maintained, and the lessor’s reporting requirement in an operating lease transaction. This regulation also contains rules regarding when the taxpayer’s substantiation requirement will be deemed satisfied with respect to the amount upon which California sales or use tax has been paid pursuant to “time and materials,” “lump-sum,” or “turnkey” contracts.

Regulation 17053.49-11 provides miscellaneous rules applicable to the MIC. Specifically provided are the operative dates of the MIC, the interaction of the MIC with the LARZ credits, information on the election to claim a sales and use tax refund under CRTC Section 6902.2 in lieu of the MIC, and information on the sales and use tax exemption under CRTC Section 6377. The rules and cross-reference in this regulation have been drawn from other places in the CRTC that may not otherwise be readily apparent to taxpayers who wish to claim the MIC.

#### Necessity:

The Legislature enacted Sections 17053.49 and 23649 to provide income and franchise tax incentives to encourage the growth and expansion of manufacturing activities and jobs within California. In doing so, the Legislature drafted two very complex statutes that use numerous terms of art and refer to concepts that are not otherwise defined. The FTB carefully reviewed these statutes and determined that there existed sufficient uncertainty and complexity to require supplemental information be provided to the public in the form of regulations interpreting and clarifying provisions of the MIC.



A team of FTB staff members was formed to consider whether regulations or other public guidance relating to the MIC was necessary. Following initial discussions, staff decided to conduct a public symposium on January 17, 1995, to solicit input from affected members of the public. During the symposium, which was attended by approximately fifty members of the public, the public and staff identified numerous issues which those in attendance urged should be covered by any regulations to be drafted.

FTB staff received additional written comments from the public following the symposium. Most of these public comments urged FTB to act quickly in adopting regulations for the MIC. Further, the SBE, which administers the sales and use tax exemption that was enacted by the same legislation as were Sections 17053.49 and 23649, and contains some overlapping language and definitions, adopted Regulation 1525.2 in January 1995. The FTB team then decided to go forward with drafting regulations to provide the public and FTB staff with clarification of some of the numerous issues raised by these complex statutes.

On June 9, 1995, FTB staff sent interested members of the public a copy of the draft regulations as part of an informal comment process. Written comments were solicited from all those members of the public who received a copy, and nine different comment letters were received. Many of these comments reflected in the draft of the regulations being noticed in connection with this initial statement of reasons. These written comments further demonstrate the need for these regulations.

Technical, Theoretical and/or Empirical Study, Reports or Documents Relied Upon:

In drafting the regulations, the FTB relied upon the statutes which established the MIC, reference to other portions of the CRTC, and the IRC contained in Sections 17053.49 and 23649, the Legislative Counsel's Digests for SB 671 (1993) and SB 676 (1994), the bill analyses for SB 671 (1993) and SB 676 (1994), written comments received pursuant to FTB Notices 94-5, 94-7, and 95-2 (these comments are available upon request), oral comments received at the FTB's January 17, 1995 symposium held in Sacramento, the SBE's Regulation 1525.2, California Integrated Waste Management Board Regulation 17940, and Sections 174, 179, 263A, 267, 318, 704, 707, 1033, 1245, 1250, and 1371 of the IRC, and the regulations there under.

Other than the items described in the preceding paragraph, the FTB did not rely upon any technical, theoretical or empirical studies, reports or documents in proposing the adoption of these regulations.

Alternatives to the Proposed Regulatory Action that would lessen any Adverse Impact on Affected Private Persons or Small Business:

No alternatives were presented to nor considered by the FTB which would be more effective in carrying out the purpose of the proposed regulations or would be as effective and less burdensome to affected private persons or small businesses than the proposed regulations. The statutes passed by the Legislature are broad in their terms and require further definition in order to ensure proper utilization of the MIC, to reduce compliance burdens upon taxpayers, and to aid in the efficient administration of Sections 17053.49 and 23649 by the FTB. However, the Board is considering two alternate regulatory actions, as discussed above, in the form of Alternatives One and Two.

## Plain English Statement

The following statement accompanied the MIC Rulemaking File:

- “These regulations help taxpayers who want to claim the MIC. The first regulation tells taxpayers when they may first qualify for the MIC (after 1993) and first claim the MIC (after 1994). It also tells taxpayers they must use the property in California for at least one year.
- The second regulation gives all of the definitions that apply to all of the other regulations.
- The third regulation describes when a taxpayer is a “qualified taxpayer” for the MIC. It also has some examples.
- The fourth regulation describes which amount will be “qualified costs” for the MIC. It also has some examples.
- The fifth regulation describes the kinds of property that are “qualified property” for the MIC. It also has some examples.
- The sixth regulation describes when “leases” can qualify for the MIC. It also has some examples.
- The seventh regulation describes the rules when a partnership, an S corporation, or an estate or trust is the taxpayer. It also has some examples.
- The eighth regulation describes what happens when a taxpayer sells “qualified property” or moves “qualified property” from California. It also has some examples.
- The ninth regulation describes the carryover rules when a taxpayer cannot use all of the MIC in one year. It also has some examples.
- The tenth regulation tells taxpayers which books and records they need to keep.
- The eleventh regulation describes other rules that apply when a taxpayer claims the MIC.”

## Comments Received During 2/13/96 Comment Period

The following correspondence and its subject matter was received by the FTB for the comment period that ended on February 13, 1996:

Bank of America (two sets of comments) - acquisition sales/leaseback; a CRTC Section 6010.65 sale and leaseback may qualify for the MIC, and such a transaction should not constitute a “disposition” under the statute.

American Financial and Tax - S corporation pass-through; there is a one-third credit offset at the corporate level for an S corporation that is in addition to the amount passed through to the shareholders.

Morrison & Foerster - sale/leaseback transactions; the MIC should not be denied where is an acquisition sale-leaseback transaction simply because no sales tax is due on the lease due to CRTC Section 6010.65.

Western States Petroleum Association (WSPA) (two sets of comments) - qualified property definition narrowed to IRC Section 1245(a)(3)(A) property; and, property used to refine reformulated or oxygenated gasoline in oil refining.

Spidell Publishing - passthrough entities; specify that the regulation provisions apply to limited liability companies as well.

New United Motor Manufacturing (NUMMI) - capitalized labor; pension costs should be included in the definition of capitalized labor.

Equipment Leasing Association (ELA) - acquisition sale/leaseback transactions; the MIC should apply to an acquisition sale and leaseback under CRTC Section 6010.65.

California Association of Equipment Lessors (CAEL) - acquisition sale/leaseback transactions; the MIC should apply to an acquisition sale and leaseback under CRTC Section 6010.65.

Comdisco - acquisition sale/leaseback transactions; the MIC should apply to an acquisition sale and leaseback under CRTC Section 6010.65.

Mitsubishi Capital, Inc. - acquisition sale/leaseback transactions; the MIC should apply to an acquisition sale and leaseback under CRTC Section 6010.65.

California Chamber of Commerce - capitalized labor definition should be expanded to include pension costs, as well as design and engineering costs; definition of qualified property should only apply to IRC Section 1245(a) property, not be limited to IRC Section 1245(a)(3)(A); definition of establishment should be expanded concerning separate establishments supporting the principal business activities of the taxpayer; and, “placed in service” requirement should not be narrowed.

General Electric Capital - acquisition sale/leaseback transactions; the MIC should apply to an acquisition sale and leaseback under CRTC Section 6010.65.

Price Waterhouse (two sets of comments) - computer software; R&D examples; replace the term “off-the-shelf” software with “prewritten software”

Ivanjack & Lambirth - sale/leaseback transactions; the MIC should apply to an acquisition sale and leaseback under CRTC Section 6010.65.

## **Index of Proposals for Alternatives One and Two**

### Alternative One - Index of Proposals

Proposal 1 - (All Qualified Taxpayers - Staff Proposals) - Add a statement as to the effect of SIC Code assignments by other public agencies on the MIC, add a clarification of how ISC Code assignments are made when multiple activities are conducted at a single physical location, add a statement clarifying that “pay-as-you-go” leases do not qualify for the MIC, add a statement clarifying that 100 percent of the MIC passes through to the shareholders of an S corporation,

clarify the reference in the disposition rules to financing transactions, and clarify the operation of the sales and use tax refund in lieu of the MIC rules.

Proposal 2 - (All Qualified Taxpayers - AEA Proposal) - Add examples to the qualified taxpayer regulation (-3) to clarify that research and development facilities that “support” the qualified taxpayer’s manufacturing or other qualified activity will be classified as “auxiliary establishments” and will be assigned the same SIC Code as the qualified activity it supports.

Proposal 3 - (All Qualified Taxpayers - Bank of America/Comdisco Proposal) - Add a limited exception, together with examples, to the “California sales and use tax payment requirement” in the case of any “acquisition sale and leaseback” transaction that is subject to CRTC Section 6010.65.

Proposal 4 - There is no Proposal Four for Alternative One.

Proposal 5 - (All Qualified Taxpayers) - Include in direct labor costs the elements of compensation attributable to engineering and design costs that are paid or incurred for the acquisition, construction or reconstruction of qualified property, but continue to exclude all other indirect labor costs, including pension and other related costs and employee benefit expenses.

Proposal 6 - (All Qualified Taxpayers) - Include in direct labor costs the elements of compensation attributable to certain specified activities that are paid or incurred for the acquisition, construction or reconstruction of qualified property, but continue to exclude pension and other related costs and employee benefit expenses.

Proposal 7 (All Qualified Taxpayers) - Include in direct labor costs the elements of compensation attributable to certain specified activities that are paid or incurred for the acquisition, construction or reconstruction of qualified property, and also include the related pension and other costs and employee benefit expenses.

#### Alternative Two - Index of Proposals

Proposal 1 - (All Qualified Taxpayers - Staff Proposals) - Add a statement as to the effect of SIC Code assignments by other public agencies on the MIC, add a clarification of how ISC Code assignments are made when multiple activities are conducted at a single physical location, add a statement clarifying that “pay-as-you-go” leases do not qualify for the MIC, add a statement clarifying that 100 percent of the MIC passes through to the shareholders of an S corporation, clarify the reference in the disposition rules to financing transactions, and clarify the operation of the sales and use tax refund in lieu of the MIC rules.

Proposal 2 - (All Qualified Taxpayers - AEA Proposal) - Add examples to the qualified taxpayer regulation (-3) to clarify that research and development facilities that “support” the qualified taxpayer’s manufacturing or other qualified activity will be classified as “auxiliary establishments” and will be assigned the same SIC Code as the qualified activity it supports.

Proposal 3 - (All Qualified Taxpayers - Bank of America/Comdisco Proposal) - Add a limited exception, together with examples, to the “California sales and use tax payment requirement” in the case of any “acquisition sale and leaseback” transaction that is subject to CRTC Section 6010.65.

Proposal 4 - (Refineries only - WSPA Proposal) - Include in the definition of qualified property “other tangible property” (as defined in IRC Section 1245(a)(3)(B) used by taxpayers in SIC Code 2911 for the production of “reformulated” or “oxygenated” gasoline (as defined in the proposal).

Proposal 5 - (All Qualified Taxpayers) - Include in direct labor costs the elements of compensation attributable to engineering and design costs that are paid or incurred for the acquisition, construction or reconstruction of qualified property, but continue to exclude all other indirect labor costs, including pension and other related costs and employee benefit expenses.

Proposal 6 - (All Qualified Taxpayers) - Include in direct labor costs the elements of compensation attributable to certain specified activities that are paid or incurred for the acquisition, construction or reconstruction of qualified property, but continue to exclude pension and other related costs and employee benefit expenses.

Proposal 7 (All Qualified Taxpayers) - Include in direct labor costs the elements of compensation attributable to certain specified activities that are paid or incurred for the acquisition, construction or reconstruction of qualified property, and also include the related pension and other costs and employee benefit expenses.

**Notice of 15-day Changes (mailed 2/29/96; Published 3/1/96)**

A hearing was held on February 13, 1996 before the three-member FTB Board to consider the adoption of Section 17053.49-0 through 17053.49-11 and 23649-0 through 23649-11 in Title 18 of the California Code of Regulations. These Sections interpret and make specific the provisions contained in CRTC Sections 17053.49 and 23649, relating to the MIC.

The proposed regulations were noticed in the California Regulatory Notice Register on December 29, 1995. The noticed regulations comprised of two alternative proposals, “Alternative One” and “Alternative Two.” After due deliberation and consideration of comments made during the public hearing process, the Board resolved to proceed with Alternative Two with the changes specified in this notice and not to proceed with Alternative One.

After consideration of comments made during the public hearing process, the Board resolved to make the following described changes to “Alternative Two” of the proposed regulations as noticed in the California Regulatory Notice Register on December 29, 1995:

Add a statement as to the effect of SIC Code assignments by other public agencies on the MIC. This change clarifies that, for MIC purposes, SIC Code assignments by other public agencies are not binding on either the taxpayer or the FTB and that such assignments are to be made based on the principles in the MIC proposed regulations.

1. Add a clarification of how SIC Code assignments are made when multiple business activities are conducted at a single physical location.
2. Add a statement clarifying that where leases are structured so that the lessee pays California use tax on each of the lessee’s payments and where the lessor does not pay sales tax on the lessor’s acquisition of the qualified property, such leases do not qualify for the MIC. This change clarifies

that “pay-as-you-go” leases, which are leases where the lessee with each rental payment pays the use tax, do not qualify for the MIC.

3. Add a statement clarifying that, in addition to an S corporation applying a limited one-third of the MIC toward the S corporation’s California income tax liability, 100 percent of the MIC passes through to the shareholders as well.
4. Clarify the reference to financing transactions in the recapture disposition rules.
5. Clarify the rules relating to the operation of the sales and use tax refund in lieu of the MIC.
6. Add examples clarifying that in making the qualified taxpayer determination for MIC purposes, that research and development facilities that “support” the qualified taxpayer’s manufacturing or other qualified activity will be classified as “auxiliary establishments” and will be assigned the same SIC Code as the qualified activity they support.
7. Add a limited exception, together with examples, to the “California sales and use tax payment requirement” in the case of any “acquisition sale and leaseback” transaction that is subject to CRTC Section 6010.65.
8. Clarify the definition of qualified property to include “other tangible property” (as defined in IRC Section 1245(a)(3)(B)) used by taxpayers in SIC Code 2911 (petroleum refiners) for the production of “reformulated” or “oxygenated” gasoline, as defined.  
The text of the proposed regulations accompanies this notice and the proposed changes are shown with double underscoring of the proposed additions and strikeout of deleted text. These nonsubstantive and sufficiently related changes are being made available to the public for the 15-day period required by Government Code Section 11346.8(c) and Section 44 of Title 1 of the California Code of Regulations.

## Summary of Comments and Recommendations

The following are the FTB staff responses and proposed recommendations to the public comments received:

### 1. “Placed in Service” Requirement

Comment: Proposed Regulations 17053.49-1(b) and 23649-1(b) generally specify that the MIC be allowed as of the date that the qualified property is “placed in service.” This limitation is unjustified by the statute. The use of the term “placed in service” in the statute is a “geographical” requirement intended to ensure that the MIC is for property located in California, and is not meant to require that the property actually be used in California before the MIC may be claimed. (*California Chamber of*



*Commerce)*

Response: The language of CRTC Sections 17053.49(d)(1) and 23649(d)(1), which sets forth the elements of the “qualified property” definition, specifically requires that property be “placed in service” in a “tax accounting” sense prior to the taxpayer claiming the MIC. The specific language that supports this interpretation is that property “is primarily used for any of the following: (A) For the manufacturing, processing ...” (Emphasis added.) Under this language, prior to the time property is actually placed in service, the taxpayer cannot “primarily use” the property in one of the specified qualified activities, and thus the property would not be qualified property within the meaning of CRTC Section 17053.49(a) and (d) and 23649(a) and (d). In addition, unlike the old federal investment tax credit, which had specific provisions under which a taxpayer could elect to claim a credit prior to the placed in service date if the taxpayer had “qualified progress expenditures,” the MIC has no similar statutory provisions which would permit a taxpayer to claim the MIC prior to the placed in service date.

Recommendation: No change needs to be made to the proposed regulations.

2. Definitions - “Indirect” Capitalized Labor Costs

Comment: Proposed Regulations 17053.49-2(c) and 23649-2(c) should be changed so that the MIC may be allowed for both direct and indirect labor costs where those indirect labor costs “directly benefit” and “are incurred by reason of” the installation of equipment. The MIC proposed regulations should not selectively use some concepts in the federal uniform capitalization (UNICAP) regulations without adopting the total approach of the UNICAP regulations and should reach the same result that would be reached under the UNICAP regulations with regard to capitalized labor. Furthermore, using the UNICAP regulations in this way and capitalizing both direct and indirect labor costs which “directly benefit” and “are incurred by reason of” comports with the statutory requirement of CRTC Sections 17053.49(c)(2) and 23649(c)(2) that the “capitalized labor costs” be “directly allocable” to the construction, reconstruction or acquisition of qualified property. Specifically, design and engineering costs, which are defined in IRC Section 263A as “indirect” labor costs, should be treated as qualified costs for the MIC. (*California Chamber of Commerce; New United Motor Manufacturing*)

Response: Using the UNICAP rules of IRC Section 263A provides both taxpayers and the FTB with well-established rules that can be understood and administered. In fact, the specific portion of the UNICAP rules that distinguish between direct and indirect labor costs have been in existence



for over 20 years in the “full absorption” inventory tax accounting rules applicable to manufacturers under IRC Section 471 (to which California conforms). In addition, the MIC statute includes as qualified costs “any capitalized labor costs that are directly allocable to the construction or modification” of qualified property. (Emphasis added.) In the context of the MIC, the Legislature’s intent to expressly limit the scope of the “capitalized labor” component of the MIC to those labor costs that are actually “direct” labor costs, since absent such an intention, the term “directly” would have simply been omitted. The UNICAP rules represent a reasonable approach for defining “direct” labor costs.

Recommendation: No change needs to be made to the proposed regulations. However, the FTB staff will conduct a public symposium on this issue on March 27, 1996, and the FTB may consider amendment of these proposed regulations at a later date.

### 3. Definition of Qualified Taxpayer - Auxiliary Establishments

Comment: Proposed Regulations 17053.49-3 and 23649-3 should be modified to provide that where a separate establishment is conducting activities that are in support of the principal business of the taxpayer, and those activities are qualifying activities as defined in the proposed regulations, then the separate establishment shall be treated as an auxiliary establishment. (*California Chamber of Commerce*)

Response: The proposed regulations already provide for this result. The rules for determining a taxpayer’s SIC Code(s) are identical to those for the classification of SIC Codes in the SIC Manual, 1987 edition.

Recommendation: No change needs to be made to the proposed regulations.

### 4. Definition of Qualified Taxpayer - Examples Illustrating the “Auxiliary Establishment” Concept

Comment: A proposal was made that certain examples be added to Proposed Regulations 17053.49-3 and 23649-3 regarding research and development activities and their relationship to the determination of an auxiliary establishment. (*Price Waterhouse*)

Response: Examples can be added to help illustrate and clarify the auxiliary establishment concept in the context of research and development facilities.

Recommendation: Three examples were added to the proposed regulations.

## 5. Definition of Qualified Property - “Off-the-Shelf” Computer Software

Comment: The references in Proposed Regulations 17053.49-5 and 23649-5 to the term “off-the-shelf” computer software does not encompass all of the types of computer software that are sold in California and are subject to California sales tax. The phrase “off-the-shelf software” should instead be replaced with the phrase “prewritten software.” (*Price Waterhouse*)

Response: CRTC Sections 17053.49(d)(4) and 23649(d)(4) specifically provide that qualified property includes “off-the-shelf” computer software upon which California sales or use tax has been paid. Thus, the proposed regulations simply repeat the statutory phrase and should not be changed or modified.

Recommendation: No change needs to be made to the proposed regulations.

## 6. Definition of “Qualified Property” - “Other Tangible Property”

Comment: Proposed Regulations 17053.49-5 and 23649-5, in both Alternative One and Alternative Two, too narrowly define “qualified property” for the MIC by requiring that qualified property be, among other things, “tangible personal property” defined in IRC Section 1245(a)(3)(A). The definition used in the proposed regulations excludes from qualified property any property described as “other tangible property” under IRC Section 1245(a)(3)(B). Neither the statutory language nor the legislative intent supports this definition. If the FTB chooses to adopt one of the two alternatives, it should adopt Alternative Two. (*Western States Petroleum Association; California Chamber of Commerce*)

Response: CRTC Sections 17053.49(d)(1) and 23649(d)(1) provide that qualified property includes, among other things, “tangible personal property as defined in IRC Section 1245(a).” Since only IRC Section 1245(a)(3)(A) references the term “personal,” the statute refers only to property described in IRC Section 1245(a)(3)(A). This approach was embodied in Alternative One. However, the legislative history, and particularly the revenue estimated accompanying SB 671 (1993), demonstrate that the amounts to be expended by the oil industry for “other tangible property” in re-tooling their refineries to refine reformulated or oxygenated gasoline was contemplated and intended by the Legislature to qualify for the MIC. This approach was embodied in Alternative Two.

Recommendation: On February 13, 1996, Alternative Two was adopted by the FTB with nonsubstantive changes to the language of Proposed Regulations 17053.49-5 and 23649-5.

7. “Acquisition Sale and Leaseback” Transaction - “Deemed” Payment of California Sales or Use Tax

Comment: Proposed Regulations 17053.49-6 and 23649-6 should allow costs paid or incurred as a result of an “acquisition sale and leaseback” (as defined in CRTC Section 6010.65) transaction to be treated as qualified costs for purposes of the MIC. This rule should be an exception to the general rule in the proposed regulations that requires the lessor to pay the California sales or use tax upon the lessor’s acquisition of the qualified property in order for the costs to be treated as “qualified costs.” This should be accomplished by providing that, in the case of an “acquisition sale and leaseback” transaction that qualified under CRTC Section 6010.65, the sales and use tax payment requirement should be “deemed” satisfied. Suggested regulatory language was submitted with some of the comments. (*Bank of America; Morrison & Foerster for Comdisco; Equipment Leasing Association; California Association of Equipment Lessors; Mitsubishi Capital; Landels, Ripley & Diamond for General Electric Capital; Ivanjack & Lambirth*)

Response: CRTC Sections 17053.49 and 23649 provide that “... the amount of original cost to the lessor which may be taken into account ... shall not exceed the purchase price upon [California] sales tax reimbursement or use tax has been paid...” In the case of an acquisition sale and leaseback transaction that qualified under CRTC Section 6010.65, the lessor is precluded from paying sales tax reimbursement or use tax on the lessor’s acquisition because California sales tax law ignores the transaction for sales and use tax purposes, with the result that the lessor (and by extension the lessee) could never have any qualified costs upon which the MIC may be claimed. As a result, providing an exception in this limited context is consistent with the legislative intent of allowing leasing transactions to qualify for the MIC generally, while still retaining the requirement that California sales or use tax must be paid in any transaction where it can be paid.

Recommendation: The proposed regulations were changed to provide that, in the case of any sale and leaseback transaction that is properly treated as an “acquisition sale and leaseback” under CRTC Section 6010.65, the requirement of Proposed Regulations 17053.49-6(b)(2)(C) and 23649-6(b)(2)(C), relating to payment of California sales or use tax, shall be “deemed” satisfied by the lessor. Examples were also added to illustrate this exception and its limitations.

8. Addition of Reference to “Limited Liability Companies” to Pass-Through Entity Rules

Comment: Proposed Regulations 17053.49-7(a) and 23649-7(a), relating to the pass-through entity rules, should also include a reference to limited

liability companies. (*Spidell Publishing*)

Response: Limited liability companies (LLCs) are generally treated for California income tax purposes as partnerships, and thus LLCs are pass-through entities with the same tax consequences to the “members” of the LLC as to a partner in a partnership. However, under certain limited circumstances, a LLC may instead be treated as an “association taxable as a corporation” for California income tax purposes, so that the LLC would no longer be treated as a pass-through entity. As a result, it is unnecessary for the MIC proposed regulations to contain any specific reference to the rules applicable to LLCs since which set of rules will apply is wholly independent of the MIC.

Recommendation: No change needs to be made to the proposed regulations.

#### 9. Clarification of S Corporation Pass-Through Rule

Comment: Proposed Regulations 17053.49-7 and 23649-7 should make it clear that in the case of an S corporation, the MIC is allowable to both the S corporation (one-third of the credit earned may be applied against the S corporation 1.5% entity-level tax) and the shareholders (100% of the credit earned) of the S corporation receiving pass-through of the MIC. (*American Financial and Tax*)

Response: Proposed Regulations 17053.49-7 and 23649-7 do not specifically state the general rule that, unless otherwise limited, credits may be applied against the 1.5% S corporation entity-level tax (under CRTC Sections 17039 and 23036), as well as 100% of the credit, without reduction, also being passed-through to the shareholders of the S corporation.

Recommendation: Proposed Regulations 17053.49-7(c)(1) and 23649-7(c)(1) were changed to add a specific sentence to clarify the principle that even if an S corporation applies their one-third of the MIC earned against the entity-level tax, 100% of the MIC may still be passed-through, without reduction, to the shareholders of the S corporation.

#### 10. “Acquisition Sales and Leaseback” Transactions - Exception to “Disposition” Rule

Comment: Proposed Regulations 17053.49-8 and 23649-8 should provide that an acquisition sale and leaseback is not treated as a “disposition” under the recapture rules and thus does not trigger recapture of the MIC. This change would be consistent with the SBE’s Sales and Use Tax Regulation 1525.2(I)(2), which provides that an “acquisition sales and leaseback” transaction under CRTC Section 6010.65 does not forfeit the

partial sales/use tax exemption allowed under CRTC Section 6377. A similar exception for acquisition sale and leaseback transactions should apply to the MIC. (*Bank of America; Morrison & Foerster for Comdisco; Equipment Leasing Association; California Association of Equipment Lessors; Mitsubishi Capital; Landels, Ripley & Diamond for General Electric Capital; Ivanjack & Lambirth*)

Response: A transfer to an unrelated party (as defined), within one year from the date the qualified property is placed in service, triggers a recapture of the MIC as required under CRTC Section 17053.49(g) and 23649(g). In an acquisition sale and leaseback transaction, the lessee acquires the qualified property, usually places it into service, and thereafter sells the qualified property to a lessor and simultaneously leases the property back. Since the lessee's credit is recaptured upon transfer to the lessor and since the lessor is precluded under CRTC Section 6010.65 from paying California sales tax reimbursement or use tax on the lessor's acquisition, there are no qualified costs to the lessor upon which the lessee may claim the MIC. While FTB staff is generally sympathetic to the unfortunate result this creates for potential users of manufacturing property in California, staff prefers to amend the "sales tax payment" requirement, as discussed in the Response to Comment 7, so as to avoid creating an unadministrable exception to the recapture rules. This effectively accomplishes virtually the same result, and still provides a MIC to the user of the qualified property.

Recommendation: Instead of creating an exception to the "disposition" rules in proposed Regulations 17053.49-8 and 23649-8, Proposed Regulations 17053.49-6 and 23649-6 were changed to "deem" California sales or use tax to have been paid in the limited case of an "acquisition sale and leaseback" transaction. As a result, no change to Proposed Regulations 17053.49-8 and 23649-8 were made.

### **FTB Resolution Regarding Alternative Two of Proposed Regulation**

Sections 17053.49 and 23649 of the CRTC provide an income and franchise tax credit equal to 6 percent of qualified costs for certain qualified taxpayers with respect to qualified property placed in service in California. This credit is commonly referred to as the "Manufacturers' Investment Credit" (MIC), and is available for qualified costs paid or incurred on or after January 1, 1994. Additionally, the MIC may not be claimed until the qualified taxpayer's first income or taxable year beginning on or after January 1, 1995.

On December 29, 1995, the FTB caused to be published a Notice of Hearing on two alternatives of proposed Regulations 17053.49-0 through 17053.49-11 and 23649-0 through 23649-11 (hereinafter "Alternative One" and "Alternative Two"). The public hearing on each of these alternative proposed regulations was scheduled for February 13, 1996. Each of these alternative proposed regulations interpret and implement the provisions contained in Sections 17053.49 and 23649 of the CRTC.

Based on written comments received and oral presentations made at the public hearing, the Board has considered the adoption of either Alternative One or Alternative Two of the proposed Regulations Section 17053.49-0 through 17053.49-11 and 23649-0 through 23649-11, as noticed on December 29, 1995.

Further, based on written comments received and oral presentations made at the public hearing, the Board has also agreed to certain amendments to the text of the proposed Regulations. These amendments, which are labeled as “Proposals,” are attached to this resolution. Each of the amendments made by the FTB under this resolution are either nonsubstantial or solely grammatical or are so sufficiently related to the original text of the proposed regulations, that the public was adequately placed on notice that the changes could result from the originally proposed regulatory action.

Accordingly, the Executive Officer of the FTB is hereby authorized to make available the proposed regulation as noticed on December 29, 1995, including the amendments made available to the public at the hearing of February 13, 1996, as required by the Administrative Procedures Act. If no public comments are received within 15 days of the changes being made available objecting to these changes, or, if after the submission to the Board itself of any such comments, no Member of the Board within 10 days of being supplied such comments requests further consideration of these changes, the Board, pursuant to the authority granted to it by Section 19503 of the CRTC, authorizes the Executive Officer to: (1) adopt Alternative Two of the proposed regulations as amended at the hearing on February 13, 1996, and (2) to further process the proposed regulation in accordance with the provisions of the APA and this Resolution.

### **Final Statement of Reasons**

The proposed regulations do not impose any mandate on local agencies or school districts.

### **Update of Initial Statement of Reasons**

The public notice required by Section 11346.4 of the Government Code was mailed on December 28, 1995 and published in the *California Regulatory Notice Register* on December 29, 1995, for a hearing to be held before the three-member FTB on February 13, 1996.

The hearing was held on February 13, 1996, and oral testimony was received from five individuals representing various interests. Sixteen written comment letters were received during the comment period ended February 13, 1996. At the hearing, several sets of alternative proposals for changes to the proposed regulations were presented to the Board and distributed to the public. The Board resolved to adopt some of the changes, subject to its review of any comments that might be received regarding the changes that were made, and directed staff to proceed with the 15-day notice of these changes as required by the APA. The comments received during the comment period ended February 13, 1996, were summarized, responded to and recommendations made.

Notice of the 15-day changes were mailed on February 29, 1996 and published on March 1, 1996. To meet the requirements of Section 44 of Title 1 of the California Code of Regulations, the comment period ended March 18, 1996. No comments were received during this period. In the preparation of the text of the proposed regulations to be sent to the Secretary of State's Office, a typographical error was discovered in the second sentence of proposed Regulations



17053.49-6(a) and 23649-6(a), as noticed on March 1, 1996. The sentence is shown below in underscore of the correct word and strikeout of the typographical error:

Generally, the lessor must pay California sales tax on the ~~lessee's~~ lessor's acquisition of the qualified property in order for the lessee to claim the credit for that items of qualified property.

#### Alternatives Determined

The FTB has determined that no alternative would be more effective in carrying out the purposes for which the regulations are proposed or would be as effective and less burdensome to affected private persons than the proposed regulations.

***Chris Micheli** is an attorney and registered lobbyist for the Sacramento governmental affairs firm of Carpenter Snodgrass & Associates, where he specializes in tax legislative affairs and controversy work. He was the chief lobbyist on the original MIC statute and participated in the rulemaking process on the MIC Regulations. He advises clients on claiming the MIC and may be contacted at (916) 447-2251 or [cmicheli@carpentersnodgrass.com](mailto:cmicheli@carpentersnodgrass.com).*