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Got Credits?

Top Tax Strategies for California Businesses in 2018

Many companies operating within California are finding themselves in the enviable position of needing to expand its headcount and facilities to meet market demands. Throughout each stage of the expansion process, from concept to construction to a finished building, there are three specific tax strategies California-based companies can employ to reduce their tax burden. As each phase of the expansion project is completed and each tax strategy is used the tax savings potential grows exponentially.

California Competes Tax Credit

In the California Competes Tax Credit (CCTC) program's 2017–18 fiscal year, the California Governor's Office of Business and Economic Development (GO-Biz) is authorized to negotiate more than $230 million in California income tax credits over three application periods. With the first application period valued at $75 million completed, an additional $100 million is available during the second application period, which opened Jan. 2.

Who Qualifies: GO-Biz's goal is to incentivize businesses to grow new full-time jobs and capital investments in California. For that reason, the CCTC is available to businesses located in *and* out of California. While CCTC awards are available to any type of business, two activities have dominated the list of awardees since the program began in 2014: manufacturing and R&D.

How It Works: Businesses that apply for the CCTC compete against one another based on the amount of California full-time jobs they're projecting to create and how much they intend to spend in California capital investments over the next five years. Awards have gone to businesses growing several hundred full-time jobs and spending well into the tens of millions in capital investments, as well as businesses growing far fewer jobs and spending far less on investments. This is especially true for those performing manufacturing or R&D activities.

As each phase of the expansion project is completed—and each tax strategy is used—the tax savings potential **grows exponentially**.

With two application periods left in 2018 (January and March), a company's application timing is critical. CCTC law sunsets June 30, the end of the state's 2017–18 fiscal year.

Example: A manufacturer of optical devices is growing rapidly, but that growth is putting pressure on existing resources. The company plans to expand its California headquarters and hire staff, which makes it a prime candidate for the CCTC. It develops a compelling story for the CCTC selection committee and is successful in receiving $750,000 to reinvest into its business.

Partial Sales and Use Tax Exemptions

The California Department of Tax and Fee Administration (CDTFA) issued two regulations that allow businesses to claim a partial sales and use tax exemption: One for costs associated with manufacturing and R&D and another for purchases of agricultural equipment. Each regulation has the potential to provide significant tax savings for California-based companies.

Manufacturing and R&D—Regulation 1525.4: This regulation allows a 3.9375 percent partial sales and use tax exemption for qualified tangible personal property used in manufacturing and R&D activities as defined in the 2012 North American Industry Classification System codes 3111-3399, 541711 and 541712. After Jan. 1, 2018, electric power generators whose activities fall under 2012 NAICS codes 22111-221118 and 221122 will also qualify for the partial exemption.

Agriculture—Regulation 1533.1: This allows for a 5.25 percent exemption from sales and use tax on purchases of farm machinery and equipment used in qualified agricultural activities described in the 1987 Standard Industrial Classification Manual in major groups 01, 02 and 07.

Who Qualifies: A company with activities in California that meets the definition of manufacturing, R&D or electrical power generation can qualify for the partial sales and use tax exemption for purchases of qualified tangible personal property when that property is used in those qualified activities, even if those aren't its main activities. Provided it is conducting a qualified activity in some capacity, a company can qualify for the partial exemption as a legal entity or as an establishment of a legal entity, such as being accounted for in a separate cost center, division or physical location.

The agriculturally focused Regulation 1533.1, on the other hand, is limited to ranchers, farmers and most agricultural businesses. Persons who assist a qualified rancher, farmer or grower in the production and harvesting of agricultural products may also qualify for the exemption.

How It Works: The tax savings for companies that claim a partial sales and use tax exemption on qualified tangible personal property is approximately $39,000 for every $1 million in qualified spending and about $52,000 for qualified agricultural equipment purchases.

Qualified tangible personal property is any machinery and equipment used for manufacturing or R&D that has a useful life of at least one year, including component parts and contrivances. After Jan. 1, 2018, the definition also includes any machinery and equipment used for electric power generation, which could include:

- Equipment and devices used or required to operate, control, regulate or maintain the machinery, including computers and computer software;
- Equipment or devices used in pollution control; and
- Special-purpose buildings and foundations with at least 50 percent of their floor space dedicated to manufacturing, processing, fabricating, refining or research.

The partial exemption may also extend to items used in nonqualified activities, provided qualified activities comprise 50 percent or more of the equipment's use on the property. Any company that has qualifying activities in California can claim the exemption until June 30, 2030. The agricultural exemption ends July 1, 2022. Businesses that have overpaid tax from the July 1, 2014, inception of the exemption may qualify for refunds. However, the California statute of limitations is three years, so tax credits may expire if a protective claim for refund isn't filed.

Example: Our optical devices manufacturer is planning to engage a contractor to build a facility in California to house the company's manufacturing and R&D divisions. The construction is estimated to cost $60 million, plus an additional $40 million for the machinery. An additional $25 million is budgeted for R&D equipment. The building contractor can obtain a 3.9375 percent tax savings for purchases of materials, which can be passed to the manufacturer in the form of a reduced contract price. In a typical construction contract, materials can make up 50 percent of a contract price, so in this particular scenario, the company could see this type of tax savings on the project.

Cost Segregation

When a California business purchases, remodels or constructs a new building, it may defer federal and state taxes through cost segregation. This strategy, which separates a portion of building components into their proper asset classifications with shorter recovery periods, allows businesses to front-load their depreciation deductions into the early years of asset ownership. In doing so, a company is able to increase cash flow in the near term by lowering its tax burden.

When a California business purchases, remodels or constructs a new building, it may defer federal and state taxes through **cost segregation**.

Who Qualifies: Companies operating anywhere in the United States can benefit from cost segregation, provided they own or lease real estate. California's high state tax rates make cost segregation especially useful for companies with California operations looking to reduce their tax burden.

How It Works: Cost segregation may be applied to almost any facility. Cost segregation professionals use engineering and cost-estimating techniques to identify building components that can be considered nonstructural and part of the machinery, or closely related to the business activity. These identified assets may qualify for shorter tax lives of five, seven and 15 years, rather than the standard 39 years for commercial properties and 27.5 years for residential rental properties. Cost segregation studies will analyze and provide support for the assets' tax positions.

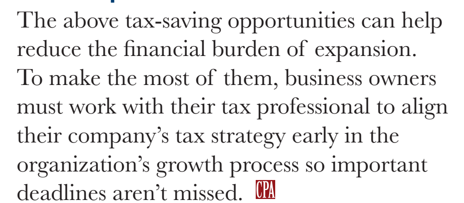
Example: The full amount of our optical devices manufacturer's $60 million facility is usually depreciated over 39 years. Without taking a closer look at the construction costs through a cost segregation study, only $6,987,000 of depreciation expense would be recognized over the first five years using the standard straight-line method.

A cost segregation study, however, identified a significant portion of the electrical and plumbing systems related to manufacturing and R&D functions. The study also found extra costs were incurred during construction to create thicker concrete foundations to support heavy manufacturing equipment. The study reallocated 10 percent of the construction cost to 15-year site improvements and 20 percent to five- and seven-year tangible personal property.

New site improvements and tangible personal property can also qualify for federal bonus depreciation in the first year and use accelerated Modified Accelerated Cost Recovery System depreciation methods instead of the straight-line method. Identifying a combined 30 percent of construction costs to their proper shorter recovery periods yields a depreciation expense of $19,682,000 over five years, an increase of $12,695,000 from the standard amount. Assuming a combined tax rate of 40.75 percent and adjusting for California's depreciation rules, the cost segregation study provides a potential tax deferral of approximately $5 million in combined federal and California state income taxes over the first five years.

Next Steps

The above tax-saving opportunities can help reduce the financial burden of expansion. To make the most of them, business owners must work with their tax professional to align their company's tax strategy early in the organization's growth process so important deadlines aren't missed. CPA



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