



California Manufacturers' Investment Credit

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Introduction

In 1993, to stimulate employment in California, the Legislature enacted three key incentives.

First, under the corporation franchise tax and personal income tax laws, the Legislature added a 6 percent investment tax credit (MIC) for the purchase of certain property (generally machinery and equipment) purchased for use by qualified taxpayers who are engaged in manufacturing activities. California Revenue and Taxation Code (RTC) §§ 17053.49 (PIT) and 23649 (CFT).

Second, under the sales and use tax law, a partial sales or use tax exemption was enacted for new or start-up companies engaged in manufacturing activities. The exemption is limited to 5 percent of qualified costs (compared to the 6 percent state sales tax rate). The exemption generally applies to the same property as the MIC. Taxpayers must elect either the MIC or the sales tax exemption. They may not claim both. RTC § 6377.

Finally, in lieu of claiming the MIC or the sales tax exemption, taxpayers are allowed to file a claim for refund with the State Board of Equalization (SBE) for the sales or use taxes paid. The refund is an amount equal to the income tax credit that would have been allowed to offset current year tax liability. RTC § 6902.2.

This article will focus on the MIC and will lead you through the maze which the Franchise Tax Board (FTB) has created in this area.

I. Background of MIC

A. Requirements for Claiming MIC

1. Generally, a "qualified taxpayer" is allowed an MIC equal to 6 percent of the "qualified costs" paid or incurred for "qualified property" that is placed in service in California after January 1, 1994.
 - a. The MIC for qualified costs paid or incurred in 1994 must be claimed on the qualified taxpayer's return for 1995.

2. Qualified taxpayer, qualified costs and qualified property are the three requirements for claiming the MIC. All three must be met for the taxpayer to claim the credit.
3. There is a tension between the MIC statute and the FTB's regulations and other administrative pronouncements interpreting the same.

B. Research Tools

1. Statutes

- a. The MIC statute is critical to review and is the starting point.
- b. RTC § 17053.49 (PIT).
- c. RTC § 23649 (CFT).

2. Regulations

- a. Throughout its regulations, the FTB has taken a narrow approach to the MIC.
- b. Title 18 California Code of Regulations sections 17053.49-0 to 17053.49-11 (PIT).
- c. Title 18 California Code of Regulations sections 23649-0 to 23649-11 (CFT).

3. FTB Manuals

- a. Multistate Audit Technique Manual (MATM) section 9120.
- b. General Tax Audit Manual (GTAM) sections 20421-20426.

4. FTB MIC Website

- a. www.ftb.ca.gov/geninfo/credits/mic/references/index.html.

California Begins Taxing Workers' Compensation Deductibles follows on page 9 of this bulletin.

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- b. Broken down into four sections.
 - (1) FTB Manuals and Publications
 - (2) Other FTB references
 - (3) Non-FTB references
 - (4) Code, Regulations, Notices and Rulings
- c. Contains links to these resources.
- 5. Publications/Forms
 - a. FTB Publication 1113 (Frequently Asked Questions)
 - b. FTB Form 3535
 - (1) Must be used by taxpayers to claim the MIC.
 - c. FTB Tax News Articles – monthly publication.
 - (1) March/April 2001 – “Manufacturers’ Investment Credit Lives On” (p. 5);
 - (2) January/February 2001 – “Manufacturers’ Investment Credit: Research and Development Activities” (p. 10);
 - (3) November/December 2000 – “Finance or Operating Lease? Client Needs to Make Distinction in Order to Qualify for MIC Credit” (pages 7-8);
 - (4) September/October 2000 – “Manufacturers’ Investment Credit – Qualified Property Plays Major Role in Claiming Credit” (pages 6-8);
 - (5) September/October 2000 – “Common Errors to Avoid With Other MIC Elements” (p. 8);
 - (6) March/April 2000 – “FTB Accepts BOE Use Tax Audits” (p. 9);
 - (7) September 1999 – “Manufacturers’ Investment Credit: For Your Information” (p. 10);
 - (8) September 1999 – “Some Leases Qualify for the MIC” (pages 10-12);
 - (9) March 1999 – “Avoid Common Errors Found With MIC” (pages 8-9); and
 - (10) July 1998 – “MIC: What ‘Qualified’ Means” (pages 10-11).
 - d. Spidell’s California Taxletter
 - (1) “Business Tax Incentives,” Oct. 1, 1993;
 - (2) “Sales Tax Exemption – Small Businesses Can Elect,” Oct. 1, 1993;
 - (3) “Credits That Reduce Regular Tax Below Tentative Minimum Tax,” Oct. 1, 1993;
 - (4) “Investment Tax Credit – A Great Idea That Needs Fine Tuning,” Jan. 1, 1994;
 - (5) “Manufacturers’ Investment Tax Credit – Changes Make It Better,” Nov. 1, 1994;
 - (6) “Manufacturers’ Investment Tax Credit Worksheet,” Dec. 1, 1994;
 - (7) “MITC and Sales and Use Tax Exemption on Leased Property,” Jan. 1, 1995;
 - (8) “Manufacturers’ Investment Credit and Sales Tax Exemption,” July 1, 1995;
 - (9) “Manufacturers’ Partial Sales and Use Tax Exemption,” Sept. 1, 1995;
 - (10) “Manufacturers’ Investment Credit Part I,” Jan. 1, 1996;
 - (11) “Manufacturers’ Investment Credit Part II,” Feb. 1, 1996;
 - (12) “Manufacturers’ Investment Credit Part III,” Mar. 1, 1996;
 - (13) “Claiming the Manufacturers’ Investment Credit – Use Form 3535 for 1994 and 1995,” Feb. 1, 1996;
 - (14) “Manufacturers’ Investment Credit – Carryovers, Recaptures, and Required Records,” Apr. 1, 1996;
 - (15) “Manufacturers’ Investment Credit – Follow-Up, Tax Traps and Clarifications,” June 1, 1996;
 - (16) “Sales and Use Tax Exemption for New Business,” June 1, 1996;
 - (17) “Manufacturers’ Investment Credit and Exemption Changes,” Dec. 1, 1996;
 - (18) “Manufacturers’ Investment Credit – Did You Overlook It?” Sept. 1, 1998;
 - (19) “FTB Audits MIC and R&D,” Feb. 1, 1999;
 - (20) “FTB Audits MIC, Third Party Capitalized Labor,” April 1, 1999;
 - (21) “MIC Legal Ruling – Position Tightened on Thorny Contractor’s Issue,” July 1, 2000; and
 - (22) “Preparing for a MIC Audit,” Sept. 1, 2001.

6. Standard Industrial Classification Manual, 1987 edition
 - a. North American Industrial Classification System (NAICS).
 7. FTB Legal Rulings
 - a. Legal Ruling 98-1, February 2, 1998
 - (1) Concerns capitalized costs of labor for engineering and design services.
 - b. Legal Ruling 2000-1, June 1, 2000
 - (1) Concerns capitalized labor costs under third party contracts. It attempts to clarify Legal Ruling 98-1 regarding the qualification of capitalized labor costs directly allocable to qualified property for the MIC.
 - c. Legal Ruling 2001-4, August 16, 2001.
 - (1) Concerns the MIC and its application to ready mixed concrete and cement trucks. It involves the issue whether the trucks are qualified property and when does the manufacturing process end.
 8. FTB Notices
 - a. Notice 2001-6, October 23, 2001
 - (1) Concerns FTB audit policy regarding use of SBE sales and use tax audit results.
 - b. Notice 2002-1, February 4, 2002
 - (1) Concerns alternative computation of capitalized direct labor costs under third party contracts.
- II. Qualified Taxpayer
- A. Definition
 1. Any taxpayer engaged in those lines of business described in 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.
 2. May be an individual, partnership, C or S corporation, LLC, trust or estate.
 - a. The MIC is determined at the entity (partnership) level (RTC §§ 17053.49(c)(2) and 23649(c)(2)).
 - b. The credit is generally allocated to the partners in accordance with the partnership agreement.
 - B. Separate But Unitary Issue
 1. It is the FTB's position that the MIC is specific to the taxpayer which earned it and cannot be allocated to other taxpayers, even if they are members of the same unitary group.
 - a. *Guy F. Atkinson Co. of California v. FTB*, No. A085075, June 12, 2000.
 - (1) In an unpublished opinion, the Court of Appeal issued a decision rejecting the taxpayer's contention that a solar tax credit should be applied against the tax liability of the unitary group, or in the alternative, should be "intra-state apportioned" against the tax liability of each of the taxpayers of the unitary group.
 - C. Taxpayer Does Not Need to be Primarily Engaged in Manufacturing Activities.
 1. *Save Mart Supermarkets*, 2002-SBE-002 (SBE, 2002)
 - a. On February 6, 2002, the SBE issued a rare formal opinion in the first MIC case to reach the Board. The SBE denied the FTB's petition for rehearing and ruled for the taxpayer.
 - (1) Formal opinions, unlike other written decisions by the SBE, are precedential and binding on the FTB and taxpayers alike.
 - b. The case involved the issue of whether Save Mart was a qualified taxpayer with respect to its bakery and meat processing activities.
 - (1) Both activities are described in Division D of the SIC Manual.
 - c. The FTB argued that Save Mart was not a qualified taxpayer because "its primary activity" was retail (not manufacturing) and therefore should be assigned SIC Code 5411. As SIC Code 5411 is not in the manufacturing section of the SIC Manual, Save Mart did not meet the statutory requirement.
 - d. Save Mart argued that it was a qualified taxpayer under the plain meaning of the statute and that the FTB's "qualified taxpayer" regulation (23649-3) was invalid because it imposed restrictions not contemplated by the MIC statute. Under that regulation, the FTB required that the taxpayer be

classified or assigned a manufacturing SIC Code while the statute only requires that the taxpayer's activities be "described in" the manufacturing section of the SIC Manual.

- e. Save Mart further argued that even if Regulation 23649-3 was somehow valid, Save Mart was a qualified taxpayer because it satisfied the three requirements under Regulation 23649-3(b)(1)(B), the "separate establishment" test.
- f. The SBE agreed with Save Mart and overturned the FTB's qualified taxpayer regulation (23649-3).
 - (1) It has been nearly 20 years since the SBE declared an FTB regulation to be invalid. The most recent example was *Standard Oil Company of California* (SBE, 1983).
- g. The SBE specifically held that the MIC statute should be liberally construed in favor of taxpayers in order to effectuate the purposes of the legislation, *i.e.*, to encourage manufacturing in the State.
- h. The SBE held that Regulation 23649-3 is interpretative and not quasi-legislative which means it is entitled to less deference on review.
 - (1) Query, what about the remainder of the MIC regulations?

III. Qualified Costs

A. Three Requirements

1. Costs paid or incurred by a qualified taxpayer for the construction, reconstruction or acquisition of qualified property on or after January 1, 1994.
2. Sales or use tax must be paid, directly or indirectly, on such costs.
 - a. Exception for costs paid or incurred for capitalized labor (Regulation 23649-4(a)).
 - b. The term "qualified costs" does not include the amount of any sales or use tax paid directly or indirectly, by the qualified taxpayer. (Regulation 23649-4(a)).
3. The costs must be properly chargeable to the capital account of the qualified taxpayer.
 - a. The costs must be properly includible in the qualified taxpayer's basis for computing depreciation on the qualified property under RTC § 24353 (Regulation 23649-4(c)).

B. Capitalized Labor

1. Qualified costs also include capitalized labor costs for the constructing or modifying of qualified property.
 - a. Must meet the definition of direct labor costs under the federal uniform capitalization (UNICAP) rules in IRC § 263A and the regulations thereunder. (Regulation 23649-2(b)(3)).
 - b. The term "capitalized labor" shall mean all direct costs of labor that can be identified or associated with and are properly allocable to the construction, modification, or installation of specific items of qualified property.
 - (1) Includes full-time and part-time employees, contract employees and independent contractors.
 - (2) Direct labor costs shall include all elements of compensation, such as basic compensation, overtime pay, vacation pay, holiday pay, sick leave pay, payroll taxes. It does not include indirect labor costs. (Regulation 23649-2(b)(1)).
 - (3) Indirect labor costs are costs that cannot be identified or associated with the construction, modification, or installation of specific items of qualified property.
 - (A) Training costs, officers' compensation, pension and other related costs.
 - (4) FTB auditors are instructed to strictly apply the tests for determining direct labor costs.
2. Legal Ruling 98-1
 - a. Issue addressed as to what extent may capitalized costs of labor paid or incurred by a qualified taxpayer for engineering and design services constitute qualified costs.
 - b. Three different factual situations set forth.
 - (1) Situation 1 deals with the issue whether third party contract costs paid to an independent contractor for engineering and design services related to a new coker would be properly treated as direct costs of labor capitalized to an item of property under IRC § 263A and thus qualified costs for purposes of the MIC. The FTB concluded they were qualified costs since they met the test under IRC § 263A, *i.e.*, the costs could be identified or associated with the new coker.
 - (A) See, however, Legal Ruling 2000-1 and Notice 2002-1.

- (2) Situation 2 is the same as Situation 1 except that the taxpayer uses the services of its own employees, not independent contractors. No separate records are kept of the time spent by each of the employees performing services for the new coker. The FTB concluded that due to the absence of the records, the regular wages and overtime paid to the employees could not be direct costs of labor capitalized to an item of property under IRC § 263A. Rather, they would be indirect costs required to be capitalized under IRC § 263A and allocated among all items of property for which these employees provided engineering and design services. Accordingly, the FTB concluded that the regular wages and overtime paid would not be includible as qualified costs for purposes of the MIC.
 - (3) Situation 3 is the same as Situation 2 except that separate records are kept on the number of hours each employee spends engineering and designing the new coker. The FTB concluded that the regular wages and overtime paid to these employees and which were related to the new coker are qualified costs for purposes of the MIC.
3. Legal Ruling 2000-1
 - a. Intended to clarify Legal Ruling 98-1 and supersedes that ruling to the extent of any inconsistency.
 - b. Issue addressed is to what extent may capitalized labor costs paid or incurred by a qualified taxpayer to a third party contractor for the construction, modification or installation of qualified property constitute qualified costs.
 - c. Retreats from Legal Ruling 98-1 and equates costs related to third party contracts with costs related to employees.
 - d. For third party contracts, a taxpayer is only allowed to include those costs which the taxpayer could include if the taxpayer itself had constructed the equipment using its own employees.
 - e. The taxpayer is required to “look through” its third party contracts and in effect put itself in the shoes of the third party contractor for purposes of computing its qualified costs for the MIC.
 - f. Burden is on the taxpayer to prove what amounts paid to the third party contractor are qualified costs.
 - g. The ruling’s application of the direct versus indirect labor costs analysis for payments to independent contractors appears inconsistent with the MIC statute and MIC regulations. *See, e.g.*, Regulation 23649-4(b), Ex. 1, 2 and 3; Regulation 23649-4(d), Ex. 3.
4. FTB Notice 2002-1
 - a. Modifies Legal Ruling 2000-1.
 - b. Purpose to provide an alternative computation provision with respect to third-party capitalized direct labor costs where a taxpayer has made a good faith effort but is unable to obtain direct labor cost data from a third-party contractor.
 - (1) Taxpayer shall calculate the direct labor cost percentage of the labor costs paid or incurred by the taxpayer to its own employees engaged in the qualified activity in which the qualified property constructed by the third-party contractor is placed in service.
 - (2) The taxpayer shall apply the percentage in (1) above to the total labor costs (excluding overhead, profit or any other non-labor costs) paid or incurred to the third-party contractor to compute the capitalized labor costs that are eligible for the MIC.
 - (3) FTB may impute a direct labor cost amount utilizing available industry labor cost data.
 5. Pending cases at SBE
 - a. *Baxter Healthcare*
 - (1) Case involves the question whether only direct costs of labor under IRC § 263A qualify for the MIC.
 - (2) Conflict between Legal Rulings 98-1 and 2000-1 a key aspect of case.
 - (3) Taxpayer arguing that the FTB regulation impermissibly narrows the scope of the statute.
 - b. *Foster Dairy Farms*
 - (1) Case involves the question whether there must be an allocation between direct and indirect labor paid to third party contractors.
 - (2) Validity of Legal Ruling 2000-1 is in issue.

IV. Qualified Property

A. Definition

1. Tangible personal property, whether new or used, that is defined in IRC § 1245(a)(3)(A).
 - a. MIC statute limits the tangible personal property to IRC § 1245(a).
 - b. MIC regulation excludes property described in IRC § 1245(a)(3)(B)-(F).
2. Must be primarily used in manufacturing, processing, refining, fabricating or recycling of property, beginning at the point at which any raw materials are received by the taxpayer and introduced into the process and ending at the point at which the manufacturing, etc., has altered tangible personal property to its completed form, including packaging, as required.
 - a. May be primarily used in research and development; to maintain, repair, measure or test any property described above; or for pollution control.
3. Off-the-shelf computer software.
4. Special purpose buildings and foundations used in certain activities.
 - a. Computer and office equipment.
 - b. Electronic components and accessories.
 - c. Commercial physical and biological research.
 - d. Biopharmaceutical.
 - e. Semiconductor equipment.
 - f. Space vehicles.
 - g. Satellites.
5. For taxpayers engaged in refining activities, qualified property also includes tangible property defined in IRC § 1245(a)(3)(B), that is used in the line of business classified in SIC Code 2911 (petroleum refining); primarily used in refining; and is used to produce reformulated gasoline or oxygenated gasoline (Regulation 23649-5(f)).
 - a. Effective on or after March 1, 1996.

B. Excluded Property

1. Furniture
2. Facilities or property used for warehousing purposes.
3. Inventory
4. Equipment used in the extraction process, such as rigging, drill bits and pumps. (Regulation 23649-5(d)(4)). Equipment used to store finished products that completed the manufacturing process.
5. Property used primarily in administration, general management or marketing.
6. Property for which the taxpayer has claimed the California low-emission vehicle credit under RTC §§ 17052.11 and 23603.

C. Key Definitions.

1. Refining
 - a. Process of converting a natural resource to an intermediate or finished product. (RTC § 23649(e)(8)).
 - b. Does not include any transportation, storage, conveyance, or piping of the natural resource prior to the commencement of the refining process (Regulation 23649-2(p)).
 - (1) This additional limitation is not contained in the MIC statute or in Regulation 1525.2(c)(7) (sales tax exemption).
2. Manufacturing
 - a. Process of converting or conditioning property by changing the form, composition, quality or character of the property for ultimate sale at retail or use in the manufacturing of a product. (RTC § 23649(e)(3)).
 - b. Improvements to tangible personal property that result in greater service life or greater functionality than that of the original property.
3. Primarily
 - a. Used 50 percent or more of the time in a qualified activity. (RTC § 23649(e)(5)).

4. Research and development
 - a. Activities described under IRC § 174 or in the regulations thereunder. (RTC § 23649(e)(9)).
 5. Recycling
 - a. Process of modifying, changing, or altering the physical properties of manufacturing, processing, refining, fabricating, or pollution control waste.
 - b. Does not include transportation, baling, shredding, grinding, compressing or any other activity that does not otherwise change the physical properties of the waste. (Regulation 23649-2(o)).
 - c. Undefined in the MIC statute.
- D. Pending Cases at the SBE
1. *Milpitas Materials*
 - a. Case involves question whether a ready-mixed concrete truck is qualified property and at what point does the manufacturing process end.
 - b. Taxpayer challenges Legal Ruling 2001-4 which was issued during the pendency of the case.
 - (1) In Legal Ruling 2001-4, the FTB concluded that the manufacturing process ends when the ready-mixed concrete reaches the job site.
 - (2) The FTB also concluded in Legal Ruling 2001-4 that only the mixing drum, and not the chassis of the truck qualifies for the MIC.
 - (3) The taxpayer challenges the FTB's bifurcation approach, while the FTB counters by pointing to old federal investment tax credit law.
 2. *Bronco Winery*
 - a. Case involves question whether certain large steel tanks qualify for the MIC or whether they are inherently permanent structures.
 - b. The taxpayer challenges the regulation's requirement that only tangible personal property under IRC § 1245(a)(3)(A) qualifies since the MIC statute only references IRC § 1245(a) property.
- E. Impact of Federal Investment Tax Credit Law.
1. FTB has looked to the concepts and definitions from the federal investment tax credit (ITC) in drafting the MIC regulations and analogized the MIC to the ITC. See FTB's Initial Statement of Reasons for the Adoption of Regulation 17053.49-0 through 17053.49-11 and 23649-0 through 23649-11.
2. Under the ITC, the credit shall be liberally construed in favor of allowing the credit.
 - a. Compare *Save Mart*.
- V. Leasing Transactions
- A. MIC Available to Lessee, Not Lessor
1. Lessee must be qualified taxpayer.
 2. Lessor must pay California sales or use tax when it acquired the property.
 3. Normal qualified cost rules do not apply.
 - a. In an operating (true) lease, a lessee may generally claim the MIC based upon the purchase price amount on which the lessor paid sales or use tax, plus any capitalized labor costs related to the lessor's construction or modification of the property.
 - b. In an operating lease, lessor must provide the lessee with a written statement within 45 days after the close of the lessee's income year, containing the amount of costs on which the lessor paid California sales or use taxes.
 - c. If the lease is a finance lease for sales and use tax purposes, then the rules applicable to it will generally apply in calculating the lessee's qualified costs.
 - (1) Finance lease is treated as a purchase.
 - (2) Rental payments are treated as payments of the purchase price.
 - d. FTB has prepared for its auditors a flowchart analyzing the differences between operating and finance leases for purposes of the MIC.
- VI. Miscellaneous Issues
- A. Recapture Rules
1. MIC is not allowed or must be recaptured in any case where a disposition occurs within one year of the date that the qualified property is first placed in service in California.

2. The term “disposition” includes the following events:
 - a. Removal of the qualified property from California;
 - b. Disposition of the qualified property to an unrelated party (sale, gift, etc.);
 - c. Use of the qualified property by the qualified taxpayer primarily in a non-qualified activity; or
 - d. Acquisition by a lessee of qualified property that is being leased by such lessee.
 3. “Disposition” does not include:
 - a. Mere transfer of legal title to a creditor that takes a security interest;
 - b. Election by a C corporation to become an S corporation; or
 - c. Destruction of qualified property that qualifies as an involuntary conversion under IRC § 1033.
 4. IRC §§ 338(g) and 338(h)(10) elections do not trigger recapture.
 - a. FTB proposal.
 - b. Chapter 543, Statutes of 2001.
- B. MIC Carryforward Rules
1. MIC may reduce the regular tax below the tentative minimum tax.
 2. Excess MIC credits may be carried forward for eight years.
 - a. Small businesses can carry forward the excess credits for ten years.
 - b. Small business means a qualified taxpayer determined as of the last day of the income year for which the MIC is allowed that meets any of the following requirements.
 - (1) Gross receipts of less than \$50 million.
 - (2) Net assets of less than \$50 million.
 - (3) Total MIC credit of less than \$1 million.
 - (4) Engaged in biopharmaceutical or biotech activities.
 - c. Small business determination made on separate entity basis.
- C. Interaction With Other Tax Incentives
1. Enterprise Zone
 - a. Sales and use tax credit for enterprise zone and MIC may be claimed.
 - (1) Reduce MIC amount by sales or use tax paid.
 - b. Enterprise Zone business expense deduction may be claimed on the same property as the MIC.
 - (1) Reduce MIC qualified costs by the deduction.
 2. Los Angeles Revitalization Zone (LARZ)
 - a. May not claim both the LARZ sales or use tax credit and the MIC for the same property.
 - b. May not claim the LARZ business expense deduction and the MIC on the same property.
- D. Recordkeeping
1. No specific requirements in the MIC statute.
 2. MIC regulations provide rules for recordkeeping by qualified taxpayers (Regulation 23649-10).
 3. Qualified taxpayer is required to maintain books and records that are adequate to substantiate its MIC claims for as long as the statute of limitations remains open.
- E. 2001 Proposed Legislation
1. Expand MIC to energy producers.
 - a. AB 1169, AB 1276, AB 96X, AB 240.
 2. Expand to oil and gas extractive industries.
 - a. AB 85X, AB 1275.
 3. Expand to renewable energy producers.
 - a. AB 45X.
 4. All failed to pass.
- F. Sunset Provision.
1. Since the MIC satisfied the requirement of increasing manufacturing jobs (excluding the aerospace sector) in California in 2000 by more than 100,000 over 1994 totals (204,000 actual count), the MIC did not sunset as of January 1, 2001.

2. Annual reports required by the Employment Development Department to the Legislature regarding manufacturing jobs.
3. The MIC shall cease to be operative on January 1 of the year in which the manufacturing jobs, as described above, do not exceed by 100,000 the total manufacturing sector employment in California on January 1, 1994.



California Begins Taxing Workers' Compensation Deductibles

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Taxation of the Business of Insurance in California

Insurance companies doing business in California are liable for insurance taxes based on “gross premiums” that are “received” by the insurer. (Cal. Const., art. XIII, §28; Cal. Rev. & Tax Code § 12221). The California Supreme Court has explained that the purpose of the tax on gross premiums is to “exact payments from insurers doing business in California; the gross premiums measure is apparently designed to approximate the volume of business done in this state, and thus the extent to which insurers have availed themselves of the privilege of doing business in California.” (*Metropolitan Life v. State Board of Equalization*, 32 Cal.3d 649, 656 (1982)).

Taxation of Workers' Compensation Deductibles

Beginning on January 1, 1995, insurers have been permitted to offer workers' compensation policies with deductibles. (Cal. Ins. Code § 11735). Under these policies, insurance companies are obligated to pay all benefits directly to the injured employee. However, the insurer can seek reimbursement for such losses up to the deductible amount specified in the policy. In return for assuming a portion of the risk, the policyholder pays a significantly lower premium than it otherwise would for a conventional policy.

Until recently, the California Department of Insurance (“DOI”) had not subjected the deductible amounts to the gross premium tax. However, on February 25, 2002, the DOI issued a notice stating that the “deductible amounts” received from insured employers are considered “gross premiums” and are therefore subject to the 2.35 percent premium tax rate during the tax year in which the amounts are actually paid. The notice stated

that the amounts must be reported on the 2001 Premium Tax Return, due on or before April 1, 2002, and that proposed assessments would be issued with respect to tax years 1997 through 2000 “in the near future.” The DOI is relying upon subsections (2) and (7) of Section 11735(e) of the California Insurance Code for the interpretation that amounts paid under the deductibles should be treated as “gross premiums” subject to tax for purposes of California’s taxing statutes.

Firm Experience

Pillsbury Winthrop LLP is currently advising an insurance association and insurance companies with regards to this matter. In addition, Pillsbury Winthrop LLP has been actively involved in insurance premium tax litigation in the past, including its successful representation of Prudential Insurance Company in *Prudential Insurance Company of America v. State Board of Equalization*, 21 Cal.App.4th 458 (1993). In *Prudential*, the court held that Prudential Insurance was entitled to a refund of gross premium insurance taxes on group health insurance contracts under which employers agreed to pay employees' claims up to an annual maximum, because the cost of claims paid by employers were not taxable as gross premiums received by and inuring to the benefit of the insurance company.

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