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Credits & Incentives talk with Deloitte

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by Kevin Potter and
Nancy Foster, Deloitte Tax LLP

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Tax Credit Carryforwards, Less May Be More

KEVIN POTTER is a Director in Deloitte's National Credits & Incentives practice. Kevin currently manages all aspects of statutory credit and negotiated incentive reviews and other similar projects for large and mid-size multistate corporations. You can follow Kevin on Twitter at Kevin_S_Potter. NANCY FOSTER is a Certified Public Accountant and has specialized in the area of California credits for over 20 years in addition to other state and federal tax statutory credits and negotiated incentives. Prior to joining Deloitte Tax she was an auditor for the California Franchise Tax Board.

Many states and localities in the U.S. utilize tax credits as a "carrot" to incentivize behaviors they want to encourage from individual and corporate citizens. This could include behavior such as hiring or investing to start or expand a business, providing health insurance or other benefits to employees, or preserving historic landmarks. However, just because jurisdictional tax credits may be generated by a company, it doesn't mean that the company will necessarily derive benefit from the credits. In fact, many companies are often left asking: Can I carry my excess tax credits forward and will I be able to fully utilize them? Did these credits come with a cost?

The answer to these questions may not be as straightforward as it seems because credit utilization may be limited due to: net operating losses, the mechanics of the credit itself, or state-imposed restrictions that apply to credit utilization in general. Also, depending on the company's future plans related to corporate structure or relocation, credit utilization may be further limited or, worse yet, non-existent.

When a business cannot utilize all of its income tax credits in the current year, in some cases the excess credits may be carried forward or utilized in an alternative fashion, such as against other taxes, or by assignment, transfer or sale.

Alternative current year utilization

One possible option for utilizing excess credits may be to apply the credits to offset something other than an income tax liability. The Georgia Quality Job Tax Credit, for example, may offset all of the taxpayer's state income tax liability and, if there is any credit leftover in a taxable year, it may be used to offset the taxpayer's withholding tax (subject to certain filing requirements and approval by the Georgia Department of Revenue), or it may be assigned to an affiliate.[1] However, if the business wishes to use the credit to offset withholding tax, the credit may be subject to a credit-per-job limitation, which is based upon the county tier.[2]

Companies can also consider assigning, transferring or selling a credit. In a previous column,[3] we wrote about credits and incentives available to the film and television industry and we outlined the Louisiana Motion Picture Investment Credit, which is transferrable or saleable and can be carried forward for up to 10 years.[4] It's extremely important to understand all of the rules impacting the credit and its utilization because the recipient/purchaser may be subject to the same limitations as the transferor/seller, which are discussed below. In many cases, an election (to assign, transfer or sell credits) is irrevocable and can only be done on an original state tax return.

Depending on the state tax credit requirements and if the statute of limitations permits, if an income tax credit cannot be utilized, an option may be to "disclaim" the credit, that is, taking those steps necessary to undo the original act of claiming the credit. The disclaiming of a credit may not be permissible in all jurisdictions. However, it may be possible to disclaim a credit if there was an add-back to state taxable income related to the credit in the year of generation and if the state would allow a business to at least recoup the tax associated with the original add-back.

Credit carryforward make-up

If a business cannot utilize an income tax credit in the current year, the business should consider whether the credit may be carried forward, though that involves a number of considerations. Being resource constrained and having more reporting requirements thrust upon them, businesses are often unable to spend the time and attention necessary to appropriately track their credit carryforwards, let alone accurately forecast their utilization.

One common phrase we hear from businesses is "where do I start?" The first option may be as simple as making sure there is an understanding of exactly what the credit carryforwards consist of, or their "make-up," such as the tax year in which the credits were generated and how much longer they can be carried over.

Next, the business should estimate the ability to utilize the credits by considering the various current and future credit limitations and changes that may occur to the credits themselves. Additionally, the business should consider the "cost" of the potential unused credit, the financial reporting requirements for the carryforwards for financial statement purposes and the possible remedies that may be available for the excess credit carryforwards.

Understanding when the credit carryforwards were generated is particularly important when the credit can only be carried over for a certain number of years. Further, taking into account whether the credit is continuously generated in the future, such as where there is an "annuity" component, may be helpful when considering the big picture and ascertaining whether all of the credit can ultimately be utilized.

For example, although the California Enterprise Zone Hiring Credit was repealed as of January 1, 2014, qualified employees hired on or prior to December, 31, 2013, may continue to generate credit for up to the first five years of their employment. If, for example, a qualified employee was hired during 2013, that person may continue to generate credit for the qualified company through 2018 if they remained qualified and active.[5]

Once it is understood when the credit carryforwards were generated, when they expire and if they continue to be generated in current and future tax years, the next consideration is when and if these credits can be utilized.

Credit utilization

When contemplating the ability to utilize state tax carryforward credits, considerations include, but are not limited to: limitations specific to the credit itself, state limitations specific to credit utilization, changes to the type of entity that originally generated the credits, relocation plans, and net operating losses.

Limitations associated with the credit itself. Each tax credit can have limitations of its own. In some cases, a credit may only be allowed to offset state income tax from the entity that generated the credit, while in other cases the credit may be allowed to offset the income tax from the combined tax reporting group. This may be helpful if the entity generating the credit has a net operating loss and other members of the group have tax liability to offset.

For example, the California Enterprise Zone Hiring Credit may only offset the income tax from the entity that generated the credit.[6] Although in California this credit may be assigned, there are additional credit utilization limitations to consider such as the requirement that the assignee have operations in the same zone as the assignor that generated the credit. For an assignee to utilize the credit, it must have payroll and/or property in the same zone in which the credit was generated.[7]

State limitations on credit utilization. The ability to utilize state tax credits may also be limited based on state requirements that restrict credit utilization to a certain percentage of state income tax. For example, the ability to utilize the Idaho Investment Tax Credit is limited to 50% of Idaho income tax after deducting certain other credits that may apply.[8]

Additionally, a state may have credit utilization rules related to the type of entity that generates the credit. For example, in California, utilization of credits attributable to a single member limited liability company ("SMLLC") is limited to the regular tax on the income related to the activities of the SMLLC. The limitation is the difference between the regular tax computed with the single owner's income, deductions, etc., attributable to just the SMLLC, and the regular tax with the single owner's income, deductions, etc., *without* the SMLLC.[9]

Changes to the type of entity that originally generated the credits. Other considerations may arise where the entity that originally generated credits later changes to another type of entity. Depending on the state's requirements where the credits were generated, all or part of the carryforward credits could be suspended or otherwise limited when a company changes from one type of entity to another.

For example, if a California C corporation changes to an S corporation, the credit carryforwards from the C corporation are subject to a one-third limitation for the S corporation only (i.e., no C corporation credit can flow to the S corporation shareholders).[10]

Conversely, if an S corporation changes to a C corporation, a state may not allow a carryforward, either because the state conforms to IRC Section 1371(b)(2)[11] or the state has a particular statute that addresses an entity change of this type.

Company relocation. Tax credit utilization may also be impacted by decisions on business location that are made after an entity has secured a tax credit. For state tax credit carryforwards that are geographically based, such as certain employee or asset tax credits, a consideration related to the ability to utilize the carryforwards may be whether there are plans to close the location, or perhaps transfer employees or move assets to another location. A recapture may apply if such transfer or closure occurs.

For instance, taxpayers should keep in mind that the ability to utilize the California Enterprise Zone Hiring Credit (discussed above) is based on payroll and property. If the taxpayer moves its employees and/or assets outside of the enterprise zone, or closes a location, there would no longer be qualified payroll or property within the zone (unless the company has other locations within the same qualified geographic location). Without the requisite payroll and property within the geographic area where the state tax credit was generated, the ability to utilize the credit may be further limited or non-existent.

Cost of unused credit

In determining the overall benefit to be derived from a credit, it is important to consider the costs associated with that credit. Costs associated with certain state tax credits that are included in carryforwards may involve internal costs of compliance (e.g., costs related to tracking the use of the credit) and external costs related to obtaining a third-party service provider's tracking tools.

Also, some states require that an amount equal to certain expenses related to a credit, or an amount equal to the tax credit itself, be added back to taxable income, resulting in the disallowance of deductions that otherwise would have been allowed on the state income tax return. Such a requirement may be considered a "cost" because taxable income is increased as a result of the credit generation.

For example, for periods on or after January 1, 2002, there is an add-back required for the New Jersey research and development credit for any basic research payments or qualified deductions for research and experimental expenditures for which a credit is claimed unless the expenditures are also used to compute a federal research credit claimed under IRC Section 41.[12] Another example applies under the California Enterprise Zone Hiring Credit where the taxpayer that generated the credit is required to reduce its otherwise allowable deduction for wages paid by an amount equal to the credit in the year of generation. [13]

Conclusion

Just because a company can generate credits doesn't always mean the company can utilize them for the reasons discussed above. While tax credit offerings can be beneficial for both a government and a business, companies should consider whether they can utilize the tax credits before incurring significant costs to secure them. If a business believes there could be utilization issues on the horizon, it may wish to consider whether other approaches may help preserve the benefit and, alternatively, whether it should seek the tax credit at all.

[1] Ga. Code Ann. § 48-7-40.24(d).

[2] Ga. Code Ann. §§ 48-7-40.24(d); 48-7-40.1; 36-62-5-1. The tier ranking of a county is done annually by the Georgia Department of Community Affairs. The tier ranking of a county determines the amount of Job Tax Credit that businesses located in that county may be entitled to receive, as well as other program requirements and benefits.

[3] 24 JMT 29 (February 2015).

[4] La. Rev. Stat. Ann. § 47:6007(C)(4).

[5] California Assembly Bill 93 (A.B. 93); Cal. Rev. & Tax Code § 23622.7.

[6] Cal. Rev. & Tax Code §§ 23622.7(d)(1)(A); 23622.7(d)(1)(C).

[7] Cal. Rev. & Tax Code § 23622.7(j).

[8] Idaho Code Ann. § 63-3029B(5).

[9] Cal. Rev. & Tax Code § 23036(i).

[10] Cal. Rev. & Tax Code § 23803.

[11] IRC § 1371(b)(2) provides in relevant part, "No carryforward, and no carryback, shall arise at the corporate level for a taxable year for which a corporation is an S corporation."

[12] N.J. Stat. Ann. § 54:10A-4(k)(11).

[13] Cal. Rev. & Tax Code § 23622.7(h).