Tax Clinic

Maximizing the benefits of general business tax credits

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Credits Against Tax

General business credits can provide significant tax benefits in the form of a dollar-for-dollar reduction to tax liability for individuals and corporate taxpayers alike. These credits, enumerated in Sec. 38(b), can be generated by a broad range of business activities ranging from hiring certain classes of employees (i.e., the work opportunity, Indian employment, and empowerment zone employment credits) to utilizing certain resources in the manufacturing process (the renewable electricity production credit, for example). Many taxpayers develop a surplus of credits that are at risk of going unused. This item discusses how excess credits might arise and how tax practitioners can help their clients convert certain credits that would otherwise go unused into a tax deduction.

Background

Sec. 38(c)(1) imposes a limitation on the amount of general business credits that can be utilized in a given tax year. Specifically, the credit allowed for a given tax year shall not exceed the excess (if any) of the taxpayer's net income tax over the greater of (1) the tentative minimum tax for the tax year or (2) 25% of the excess of net regular tax liability over $25,000. (The alternative minimum tax was repealed for C corporations; thus these taxpayers' tentative minimum tax is effectively set at zero.) As a result, business credits generally offset 75% of a taxpayer's liability.

For this purpose, net income tax means the sum of regular tax liability and alternative minimum tax liability (for taxpayers other than C corporations), reduced by the foreign tax credit and other allowable credits (not including the general business credit). Net regular tax liability means regular tax liability reduced by the foreign tax credit, nonrefundable personal credits, and certain energy-related credits. Under Sec. 39(a)(1), general business credits generated in the current tax year that cannot be utilized due to tax liability limitations are first carried back one year and then forward 20 years, subject to the same limitations in the prior and subsequent years.

It is not uncommon for taxpayers to build up a surplus of general business credits. For example, consider a corporation in the restaurant industry that undergoes significant growth over a sustained period of years. During that time, it might generate significant tax losses from bonus depreciation and might also generate significant amounts of three general business credits: the Sec. 51(a) work opportunity tax credit, the Sec. 1396(a) empowerment zone employment credit, and the Sec. 45B(a) employer Social Security

credit. In the absence of an income tax liability, the business credits will build up and carry over until the corporation either generates taxable income or the credits expire.

Depending on the magnitude of the credit surplus, such a taxpayer may have a significant amount of unused tax credits at the end of the 20-year carryover period. In the year when the tax credits are created, the taxpayer is generally required to treat an amount of its expenses equal to the credits as nondeductible. Since tax credits are a valuable tax attribute, it would be inequitable for expired credits to simply lapse without recovering the lost deductions. Congress recognized this and enacted Sec. 196 effective for tax periods after Dec. 31, 1982, which allows many (but not all) unused qualified general business credits to convert in full to a tax deduction in the subsequent tax year after the carryover period.

Sec. 196 also applies when an individual taxpayer dies or a corporate taxpayer ceases to exist before the unexpired general business tax credits can be fully utilized. Specifically, Sec. 196(b) provides that "[i]f a taxpayer dies or ceases to exist before the first taxable year following the last taxable year for which the qualified business credits could, under section 39, have been allowed as a credit, the amount described in subsection (a) (or the proper portion thereof) shall, under regulations prescribed by the Secretary, be allowed to the taxpayer as a deduction for the taxable year in which such death or cessation occurs."

In other words, the Sec. 196 deduction for unused business credits is available both where the credit carryforward period expires (Sec. 196(a)) and when a taxpayer dies or ceases to exist (Sec. 196(b)).

Sec. 196 mechanics

The mechanics of the Sec. 196(a) tax deduction are straightforward. Taxpayers simply compute their credit usage for the year, and to the extent there are unused credits remaining after the 20-year carryover period that would otherwise expire, these credits are deducted in full on the subsequent year's tax return. Although current tax forms do not include a line for a Sec. 196 deduction, common practice for C corporation taxpayers is to report the deduction as an "other deduction" and for individual taxpayers to report the deduction as an above-the- line "other adjustment" to income on Schedule 1, Part II, line 24z of Form 1040, *U.S. Individual Income Tax Return.*

The language in Sec. 196(b), which applies when a taxpayer dies or ceases to exist, is not as straightforward, leaving the computation of this deduction subject to interpretation. Sec. 196(b) contemplates the release of Treasury regulations to provide guidance on the computation methodology, but in the 40 years since Sec. 196 was enacted, regulations have yet to be issued. As such, it is up to practitioners to employ a reasonable method to compute the amount of the Sec. 196(b) deduction when a client dies or ceases to exist.

On its face, the language in Sec. 196(b) suggests that to calculate the amount of the deduction, taxpayers first compute the amount of business tax credits that can be used to offset the tax liability for the year of death or business cessation, applying the tax liability limitation discussed earlier. Credits remaining after this initial tax credit computation

convert to a Sec. 196 deduction. Next, a second version of the tax return for the year of death or business cessation is prepared with the new Sec. 196 deduction. While the inclusion of this new deduction will have the effect of lowering the taxable income and tax liability for the tax year, a literal interpretation of Sec. 196(b) (and its cross reference to Sec. 196(a)) is that the allowable amount of tax credits initially computed for this tax year are again used in the second computation of tax liability. But requiring taxpayers to recompute the allowable credit amounts after the inclusion of the original Sec. 196(b) deduction would result in a new amount of remaining credits and hence a new Sec. 196 deduction, which, in turn, would result in a revised tax liability and a new amount of allowable credits and yet another Sec. 196 deduction. The language of Sec. 196(b) does not reasonably contemplate this unnecessarily complicated circular computation.

Steps to follow: The Code's wording supports the following multistep approach to compute the deduction for unused business credits:

■ *Step 1:* Determine the amount of general business credits for the current tax year and carryovers to the year.

■ *Step 2*: Compute the regular tax liability before general business credits for the current year.

■ *Step 3:* Apply the Sec. 38 tax liability limitation to compute the amount of tax credits that can offset the current-year liability; this amount becomes a fixed amount that will be used in subsequent steps.

■ *Step 4:* Subtract the fixed amount of credits from Step 3 from the credits computed in Step 1. The residual is the amount of credits that would otherwise go unused. Pursuant to Sec. 196, this residual converts to a tax deduction.

■ *Step 5a*: If Sec. 196 is being applied due to the expiration of the credit carryforward period, the tax deduction computed in Step 4 is deducted on the subsequent year's tax return.

■ *Step 5b*: If Sec. 196 is being applied due to the death or the cessation of a taxpayer, the residual is deducted on the tax return for the year of death or cessation. Practitioners will need to prepare a second version of the tax return to incorporate the new Sec. 196(b) deduction computed in Step 4.

■ *Step 6*: The fixed amount of credits determined in Step 3 is used to offset the revised tax liability determined in Step 5b.

Sec. 196: Tax savings opportunity

Beyond the obvious application of Sec. 196 to situations where credits expire or a taxpayer dies or ceases to exist, Sec. 196 can also be used as a tax savings strategy. One such example is the use of Sec. 196 in a taxable acquisition of a business that is taxed as a C corporation.

Consider a privately held corporation that desires to sell 100% of its stock in a taxable transaction. Savvy buyers prefer to acquire assets in order to obtain a stepped-up basis that is recoverable via depreciation or amortization deductions. This is especially true in transactions involving asset-intensive businesses, with bonus depreciation providing buyers with an immediate tax write-off of some or all of the purchase price. To obtain a step-up in basis, buyers can make a timely Sec. 338(g) election, which treats the buyer's stock acquisition as if it were an asset acquisition. Under Sec. 338(a), the old target corporation is treated as having sold all of its assets at fair market value at the close of the sale date, and the target is subsequently treated as a new corporation that purchased all of the old target's assets as of the day following the acquisition date.

A downside to a Sec. 338(g) election is that the deemed asset sale will generate taxable gain or loss for the old target corporation. This is where Sec. 196 can be used as a tax savings technique. Since the old target ceases to exist after the deemed sale, Sec. 196 arguably applies, allowing corporations with general business credit carryovers to minimize or perhaps completely eliminate the tax liability generated upon the deemed sale of assets.

Let us apply this to a hypothetical transaction.

Example: The shareholders of corporation *A* desire to sell their stock for $10 million. Assume that *A* has no liabilities. *A*'s tax attributes include a federal net operating loss of $3 million and work opportunity credit carryovers of $750,000 (neither of which is subject to any limitation under Sec. 382 or 383). Buying corporation *B* desires to purchase *A*'s assets but instead purchases the *A* stock and makes a timely Sec. 338(g) election to accomplish this goal. As a result of this election, "old" *A* is deemed to sell its assets to "new" *A* in a taxable transaction. *A*'s historic tax basis in its assets is $4 million. Assume that *A* does not generate any income, loss, or business credits in its final year of operations.

"Old" *A*'s tax liability associated with the deemed sale is computed as follows:

▪ *Gain on sale*: $10 million deemed purchase price less $4 million tax basis = $6 million taxable gain (ignoring the treatment of the federal tax liability as an assumed liability).

▪ *Taxable income*: $6 million gain less $3 million net operating loss carryover = $3 million.

▪ Tax before credits = $3 million × 21% = $630,000.

▪ Maximum credit usage = $630,000 – ([$630,000 – $25,000] × 25%) = $478,750.

▪ Tax after credits = $630,000 – $478,750 = $151,250.

▪ Without the application of Sec. 196, the deemed sale results in federal tax liability of $151,250 and unused tax credits of $271,250 ($750,000 credits carrying into the year less $478,750 utilized during the year).

By applying Sec. 196(b) to "old" A (a corporation that ceases to exist), the original tax liability can be reduced by 21% of the unused tax credits as follows:

■ New Sec. 196 deduction = $271,250 ($750,000 credit carryover less $478,750 credits utilized to offset the tax on the deemed sale).

■ Post–Sec. 196 taxable income = $6 million gain less $271,250 Sec. 196 deduction less $3 million net operating loss carryover = $2,728,750.

■ Post–Sec. 196 tax before credits = $2,728,750 × 21% = $573,038.

■ Post–Sec. 196 tax after credits = $573,038 – $478,750 (fixed amount from original tax computation) = $94,288.

■ Sec. 196 tax savings = $151,250 old tax – $94,288 revised tax = $56,962 ($271,250 unused credits × 21%).

Conclusion

General business credits are a valuable tax attribute for C corporations and individuals. Practitioners should familiarize themselves with Sec. 196 to obtain maximum tax benefits for clients who would otherwise lose credits due to the credits' expiring, the taxpayer's dying, or the taxpayer's ceasing to exist.

Editor Notes

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