

CORPORATION TAX BULLETIN 2011-03

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Corporation Tax Information Bulletin Regarding the Application of Restricted Credits that can be sold and the Requirements for Sellers of Tax Credits to be Satisfied Prior to Approval of Sale.

The saleable restricted tax credit programs to which this Tax Bulletin applies are as follows: the Research and Development Tax Credit (R&D), the Film Production Tax Credit (Film), the Neighborhood Assistance Program Tax Credit (NAP), the Resource Enhancement and Protection Tax Credit (REAP), the Keystone Innovation Zone Tax Credit (KIZ), the Alternative Energy Production Tax Credit (AEP), and the Keystone Special Development Zone Tax Credit (KSDZ) (collectively the "tax credit programs").

APPLICATION OF THE RESTRICTED CREDIT TO TAX PERIODS

All of the tax credit programs require that the credit approved be first applied against the unpaid tax liability for the period in which the credit is approved. The unpaid tax liability must be satisfied before any portion of the credit can be carried forward to satisfy the tax liabilities for future years or be sold or passed through. Prior year credits will be applied on a "first in first out" (FIFO) basis until all tax liabilities are satisfied. Restricted credits will be applied before any cash payments.

Example: R&D Tax Credit for a calendar year taxpayer.

Year 1

Credit Approved 12/15/2009 – \$2,500
Tax Liability for the Period Ending 12/31/2009 – \$1,500
Portion of 12/15/2009 credit used – \$1,500
Tax Credit Carry Forward from 12/15/2009 – \$1,000

Year 2

Credit Approved 12/15/2010 – \$4,000
Tax Liability for the Period Ending 12/31/2010 – \$2,700
Portion of 12/15/2010 credit used – \$2,700
Tax Credit Carry Forward from 12/15/2010 – \$1,300
Sale of 12/15/2009 Tax Credit – \$500
Tax Credit Carry Forward from 12/15/2009 – \$500

Year 3

Credit Approved 12/15/2011 – \$1,000
Tax Liability for the Period Ending 12/31/2011 – \$2,600
Portion of 12/15/2011 credit used – \$1,000
Portion of 12/15/2009 credit used – \$500 (FIFO)
Portion of 12/15/2010 credit used – \$1,100
Tax Credit Carry Forward from 12/15/2011 – \$0
Tax Credit Carry Forward from 12/15/2009 – \$0
Tax Credit Carry Forward from 12/15/2010 – \$200

The Department of Revenue, Bureau of Corporation Taxes adheres to the following rules regarding the application of restricted credits to corporate taxpayer accounts:

- All restricted credits, either originally approved or purchased, are the first credit(s) applied to a taxpayer's liability. Complying with this rule will insure maximum utilization of the credit within the taxpayer's account. It also provides for any "cash" paid into the period to be available for transfer or refund.
- For taxpayers who are required to make quarterly estimated payments, restricted credits may be used to satisfy a quarterly liability. For credits that are sold, the original approval date of a restricted credit is always preserved on both the seller's and buyer's corporation tax ledgers.

PASS THROUGH REQUIREMENTS

Pennsylvania S Corporations (PA S Corporations), Limited Liability Companies (LLCs) and Partnerships may pass through the R&D, Film, NAP, REAP and AEP credits to their shareholders, members or partners. A request to pass through available credit should be returned to:

Commonwealth of Pennsylvania
Department of Revenue
Bureau of Corporation Taxes
Dept 280701
Harrisburg, PA 17128-0701

Include a list of the shareholders, members or partners and the amount of credit to be passed through to each on the business's letterhead, signed by an authorized representative.

PA S Corporations, LLCs, and Partnerships wishing to pass through the KIZ credit to their shareholders, members or partners must complete the appropriate section of the Department of Community and Economic Development's KIZ sale application identifying all the shareholders, members, and partners and the amount of credit to be passed through to each. The application must be returned to the Department of Community and Economic Development.

Before any credit may be passed through to its shareholders, members or partners, it must first be applied to the business's corporate tax liability, if any, for the tax year in which the credit is approved. After a credit is claimed on the business's corporate tax report, any remaining credit may be passed through by election to the shareholders, members or partners. Once an election is made to pass any remaining credit through to the shareholders, members or partners, that election may not be revoked in order to apply the credit to the business's corporate tax report.

REQUIREMENTS TO BE MET BY SELLERS BEFORE APPROVAL

A completed tax report *must be filed* for the period in which the credit was approved before the credit may be passed through, carried forward, sold or assigned. In addition, the sale or assignment of a restricted credit will not be approved if the seller has any unpaid state taxes. Therefore, a seller must have filed *all* state tax reports and returns and paid *all* state tax liabilities as of the date the Department is asked to review the seller's records as part of the process to approve the sale of a credit. If the seller has non-filed returns or reports, or unpaid liabilities, the sale will not be approved.

The KIZ statute specifically provides that if a Pennsylvania S Corporation does not have an eligible tax liability against which the tax credit may be applied, a shareholder of the Pennsylvania S Corporation is "entitled" to a tax credit equal to the product of (i) the tax credit determined for the Pennsylvania S Corporation for the taxable year; and (ii) the percentage of the Pennsylvania S Corporation's distributive income to which the shareholder is entitled. This provision applies only to Pennsylvania S Corporations participating in the KIZ program. Therefore, before a Pennsylvania S Corporation can sell a KIZ tax credit, all of its shareholders must agree to the sale. Taxpayers must complete the appropriate section of the Department of Community and Economic Development's KIZ sale application identifying each shareholder's percentage ownership in the Pennsylvania S Corporation and indicate the shareholder's consent to forgo his respective share of the pass through credit. If any shareholder does not consent, that shareholder's portion of the KIZ credit will not be available for sale and can only be passed through to that shareholder.

In addition to the requirement to file a current year tax report prior to the sale of a credit, the NAP, REAP and AEP tax credit programs also require the credit to be held for one year from the date the credit is approved or granted.

FREQUENTLY ASKED QUESTIONS

Approved Credits (Sellers):

(1) What is the “effective date” of a restricted credit?

The effective date of a restricted credit is the original approval date. This date appears on the taxpayer’s corporate tax account in the original approval year and any carry-forward years. If a credit is purchased, the original approval date also appears on the buyer’s corporate tax account.

(2) How is originally approved credit applied to an open tax liability?

For those credit programs with sale provisions, the current year’s approved credit must first be applied to that year’s tax liability. If additional liability remains and the period contains any carry forward credits from prior years, credits will be applied on a “first in, first out” (FIFO) basis.

(3) In what order will a combination of current year approved credits, purchased credits, carry forward credits from prior periods, non-saleable credits, and saleable credits be applied to the tax liability?

(Note: For taxpayers subject to both CS/FF tax and CNI tax, credits are first applied to CS/FF tax and then to CNI tax.)

- **Category 1:** First applied are: purchased credits, originally approved credits (that are not saleable and have no carry forward provision) and credits in their last carry forward year. If the liability is paid prior to utilization of all Category 1 credits, the balance of credit is removed. Any other credit available for carry forward is applied to the next tax year.
- **Category 2:** Apply that portion of the *current year approved credits* (that are required to be applied to the taxpayer’s current year before they can be sold) in order starting with the credit program having the shortest carry forward period to the credit program with the longest carry forward period.
- **Category 3:** Apply non-saleable credits starting with the credit program having the shortest carry forward remaining lifespan to the credit program having the longest carry forward remaining lifespan.
- **Category 4:** Apply saleable credits starting with the credit having the shortest carry forward remaining lifespan to the credit having the longest carry forward remaining lifespan.

(4) When is a credit available for sale?

Credits approved in the current year must first be applied to the seller's tax liability for the year in which the credit is approved. In addition, before an application for sale of a credit is approved, the Department must make a finding that the applicant has filed all required state tax reports for all years and paid all state tax due as determined by the Department.

(5) Is there a waiting period before I can sell any remaining available credit?

The NAP, REAP and AEP tax credit programs require the seller to hold the credit for one year prior to sale. Act 48-2009 removed the one year holding period for the R&D tax credit program.

(6) What is required of the seller before an application for sale is approved?

Before approval, the Department of Revenue must make a finding that the applicant has filed all state tax reports and paid all state tax due as determined by the Department.

(7) Recent legislation now makes NAP credits available for sale. Does this apply to credits approved prior to the legislation?

All NAP credits are available for sale after the credit has been held for a one-year period.

Purchased Credits (Buyers):

(8) Can a taxpayer who purchases a tax credit carry that credit forward in their account?

No, buyers of restricted credits must use the credit in the year in which the purchase or assignment is made. They may not carry over, carry back, obtain a refund of or sell or assign the credit. *Exception:* a purchaser or assignee may carry forward a film tax credit purchased or assigned in calendar year 2011 against qualified tax liabilities incurred in the next taxable year.

(9) What determines the year in which the credit must be used by the buyer?

The requirements for sale of a tax credit include filing the PA report for the tax period in which the credit was approved or granted and, in the case of REAP, NAP and AEP tax credits, the seller holding the credit for one year from the date the credit was approved or granted.

Accordingly, if an application for sale is made prior to those conditions being met, for the KIZ, R&D and Film Tax Credit programs, the Department will apply the credit to the buyer's account for the tax period open as of the date the seller's report is filed for the period in which the credit is approved or for the period as of the date the seller becomes compliant. If an application for sale is made prior to the above conditions being met, for REAP, NAP and AEP tax credits, the Department will apply the credit to the buyer's account for the tax period open as of the later of (1) the date which is one year after the date the credit was approved or granted or (2) the date the seller's report is filed for the period in which the credit is approved or granted or for the period as of the date the seller becomes compliant.

(10) Are there limits on the amount of qualified tax liability against which the purchased credit can be applied?

Yes, credits may be applied up to the following percentages of the tax liability:

R&D – 75%, KIZ – 75%, NAP – 100%, Film – 50%, REAP – 75%, AEP – 50%, KSDZ – 75%.

(11) Is there a limit to the quantity or types of credits that can be purchased?

No, the amount of credit or type of credit that can be purchased is up to the buyer. Buyers should consider the percentage limit of each type of credit when determining the amount of credit to purchase. It is the buyer's responsibility to be aware of its potential tax liability prior to any purchase. Individuals who purchase credits to apply to personal income tax must calculate their liabilities separately from their spouse and file a separate tax return.

(12) What is the order of application if multiple types of purchased credit are present on a *buyer's* account?

There is no specific order in which such credits are applied. Since the credit cannot be carried forward or back, sold or assigned, each credit will be applied up to the percentage limit of the tax liability. Any amount of credit that exceeds the credit limit is removed from the buyer's account. *Exception:* a purchaser or assignee may carry forward a film tax credit purchased or assigned in calendar year 2011 against qualified tax liabilities incurred in the next taxable year.

(13) Can the survivor of a merger use or sell a restricted credit of the merged entity?

The survivor of the merger may use a restricted credit of the merged entity to the same extent as the merged entity could have used the restricted credit. Therefore, the survivor can use or sell the restricted credit it acquired through a merger as if the credit had been originally approved for the survivor.

(14) Can an S Corporation purchase credits and claim those credits on its NRC (nonresident consolidated) return?

Credits purchased by an entity must be applied at the entity level. If an entity qualifies to file a NRC return on behalf of its non-resident shareholders, it may purchase credits to offset the tax liability associated with the NRC return, despite the fact that the NRC return is being filed on behalf of its shareholders. The use of such a purchased credit is limited to the non-resident shareholders' liability listed on the NRC return filing and the limits for application against tax liability for the type of credit purchased as described in the answer to Question 10.

Other Questions:

(15) How are restricted credits applied to the bank shares tax?

The statute defines the bank shares tax as a "spot tax" determined as of January 1 of each year. Credits approved, granted or purchased on or after January 2 of a given year can be first applied by an institution to the spot tax as of January 1 of the following year. Purchased credits are deemed to be purchased on the later of (1) the date the application for sale is submitted to the administering agency, or (2) the date all conditions (*e.g.*, holding period and/or filing of tax reports) necessary to effect the sale are satisfied.

(16) Can REAP credits be invalidated?

Section 1706-E (B) of the Resource Enhancement and Protection Tax Credit Act requires that if the State Conservation Commission determines that best management practices have not been maintained for the period required as determined by the Commission, the owner of the property upon which the project exists is required to return to the Department the amount of the tax credit granted.

(17) If a credit is approved in the current year but the business ceased activities in PA in the prior year, is there a current year filing requirement?

No filing is required and the credit may be sold.

(18) Subsequent to an approved sale, if it is determined the original awarded credit is not valid, how will this impact the buyer and seller?

The Buyer will not be held responsible for repayment of the invalid credit purchased. It is the seller's responsibility to repay the Commonwealth. The credit sale transaction will not be reversed.

(19) What is the due date for an election to pass through a carried forward credit that has reached its last eligible carry forward year?

The election to pass through credit must be received by the due date of the last year for which the credit is eligible for carry forward.

(20) Can a restricted credit awarded to a pass through entity be sold to the shareholders of the entity?

Currently there is no prohibition against the sale of a restricted credit to the shareholders of a pass through entity.

(21) How do I verify a purchased credit is on my account?

Call 1-888 PATAXES (728-2937), select option 1 then option 2 then option 5. Enter your 7 digit account id and 4 digit tax year. The automated system will playback payments and credits on the account.

(22) Quick Reference Table:

<u>Credit Type</u>	<u>Administering Agency</u>	<u>Application Deadline</u>	<u>Applicable Taxes</u>	<u>Carry Forward</u>	<u>Purchaser's Liability Offset Limit</u>	<u>Waiting Period Before Sale</u>
R&D	Dept. Of Revenue	September 15	PIT, CNI, CS/FF	Approval yr. + 15 yrs.	75%	N/A
KIZ	Dept. of Community & Economic Development	September 15	PIT, CNI, CS/FF	Approval yr. + 4 yrs.	75%	N/A
NAP	Dept. of Community & Economic Development	None	PIT, CNI, CS/FF, Bank Shares, Title Ins. & Trust Co. Shares Tax, Insurance Premiums, Mutual Thrift	Approval yr. + 5 yrs.	100%	1 year

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FILM	Dept. of Community & Economic Development	None	PIT, CNI, CS/FF	Approval yr. + 3 yrs.	50%	N/A
REAP	State Conservation Commission	None	PIT, CNI, CS/FF, Bank Shares Tax, Title Ins. & Trust Co. Shares Tax, Insurance Premiums, Mutual Thrift	Grant yr. + 15 yrs.	75%	1 year
KSDZ	Dept. of Community & Economic Development	February 15	PIT, CNI, CS/FF, Banks Shares Tax, Title Ins. & Trust Co. Shares Tax, Mutual Thrift	Approval yr. + 10 yrs.	75%	N/A
AEP *	Dept. of Environmental Protection	September 15	PIT, CNI, CS/FF	Approval yr. + 5 yrs.	50%	1 year