

FINAL PRIVATE LETTER RULING

REQUEST LETTER

13-004

COMPANY 1
NAME 1, TITLE 1
ADDRESS 1

March 15, 2012 [*sic*]

Utah State Tax Commission
Attn: Technical Research Unit
210 North 1950 West
Salt Lake City, Utah 84134

SENT VIA EMAIL taxmaster@utah.gov

RE: Utah Code §59-10-1022
Capital Gain Transactions Credit

To whom it may concern:

I am writing to request a private letter ruling from the Utah State Tax Commission regarding the application of the Utah tax credit for capital gain transactions as set forth in Utah Code §59-10-1022. Specifically, I have the following questions:

1. The language in Utah Code §59-10-1022 does not expressly include S corporations. However, page 15 of the instructions for Form TC-20S lists the capital gain transactions credit as code 04 under nonrefundable credits and explicitly states that an S corporation “may claim a credit for the short-term and long-term capital gain on a transaction if” certain requirements are met. The instructions also direct that “Nonrefundable credits on an S corporation return are entered on Schedule K and then allocated and passed-through to the shareholders on Schedule K-1.” Are S corporations eligible to generate a capital gain transactions tax credit and pass that credit on to their shareholders?

2. Assume an S corporation or partnership has a capital gain transaction and then distributes the proceeds from the capital gain transaction to its shareholders or partners. If the shareholders or partners reinvest the proceeds in a Utah small business corporation would they be eligible to receive a tax credit for capital gain transactions since the capital gain is passed through to them from the S corporation or partnership? If so, would all shareholders and partners be required to

reinvest at least 70% of the proceeds as a group, or would each taxpayer be eligible for the credit on an individual basis without regard to the actions of the other shareholders or partners?

3. Lastly, how do installment sale rules work in relation to the capital gain transaction credit? In order to qualify for a tax credit for capital gain transactions from an installment sale, is a taxpayer required to reinvest at least 70% of the total proceeds to be received in all future years, or are they only required to reinvest at least 70% of the proceeds received from any one installment?

4. In the case of a large single capital gain transaction, where it is impossible to reinvest at least 70% of the proceeds in a Utah small business corporation due to the \$2,500,000 equity cap for small businesses, is there any way to receive a prorated amount of tax credit to the extent that the proceeds are reinvested in a Utah small business corporation?

Thank you for your assistance in this matter. Please feel free to contact me at PHONE NUMBER 1.

Ruling Requested

Please confirm the above issues on behalf of the Taxpayer.

Yours very truly,

NAME 1

RESPONSE LETTER

PRIVATE LETTER RULING 13-004

December 13, 2013

NAME 1, TITLE 1
COMPANY 1
ADDRESS 1

RE: Private Letter Ruling Request on the Utah Capital Gain Transaction Credit

Dear NAME 1,

This letter is in response to your request for information on how Utah's nonrefundable capital gain transaction income tax credit ("Credit") applies to the various situations you presented. In the Analysis section below the Applicable Law section, your four questions are listed followed by the Commission's responses.

I. Applicable Law

In Utah Code § 59-10-1022, subsection (1) defines statutory terms for purposes of the Credit, subsection (2) provides the Credit, and subsection (3) provides qualifying requirements for claiming the Credit. Section 59-10-1022 states the following:

- (1) As used in this section:
 - (a) (i) "Capital gain transaction" means a transaction that results in a:
 - (A) short-term capital gain; or
 - (B) long-term capital gain.
 - (ii) In accordance with Title 63G, Chapter 3, Utah Administrative Rulemaking Act, the commission may by rule define the term "transaction."
 - (b) "Commercial domicile" means the principal place from which the trade or business of a Utah small business corporation is directed or managed.
 - (c) "Long-term capital gain" is as defined in Section 1222, Internal Revenue Code.
 - (d) "Qualifying stock" means stock that is:
 - (i) (A) common; or
 - (B) preferred;

- (ii) as defined by the commission by rule made in accordance with Title 63G, Chapter 3, Utah Administrative Rulemaking Act, originally issued to:
 - (A) a claimant, estate, or trust; or
 - (B) a partnership if the claimant, estate, or trust that claims a tax credit under this section:
 - (I) was a partner on the day on which the stock was issued; and
 - (II) remains a partner until the last day of the taxable year for which the claimant, estate, or trust claims a tax credit under this section; and
- (iii) issued:
 - (A) by a Utah small business corporation;
 - (B) on or after January 1, 2008; and
 - (C) for:
 - (I) money; or
 - (II) other property, except for stock or securities.
- (e) "Short-term capital gain" is as defined in Section 1222, Internal Revenue Code.
- (f) (i) "Utah small business corporation" means a corporation that:
 - (A) except as provided in Subsection (1)(f)(ii), is a small business corporation as defined in Section 1244(c)(3), Internal Revenue Code;
 - (B) except as provided in Subsection (1)(f)(iii), meets the requirements of Section 1244(c)(1)(C), Internal Revenue Code; and
 - (C) has its commercial domicile in this state.
- (ii) The dollar amount listed in Section 1244(c)(3)(A) is considered to be \$2,500,000.
- (iii) The phrase "the date the loss on such stock was sustained" in Sections 1244(c)(1)(C) and 1244(c)(2), Internal Revenue Code, is considered to be "the last day of the taxable year for which the claimant, estate, or trust claims a tax credit under this section."
- (2) For taxable years beginning on or after January 1, 2008, a claimant, estate, or trust that meets the requirements of Subsection (3) may claim a nonrefundable tax credit equal to the product of:
 - (a) the total amount of the claimant's, estate's, or trust's short-term capital gain or long-term capital gain on a capital gain transaction that occurs on or after January 1, 2008; and
 - (b) 5%.
- (3) For purposes of Subsection (2), a claimant, estate, or trust may claim the nonrefundable tax credit allowed by Subsection (2) if:
 - (a) 70% or more of the gross proceeds of the capital gain transaction are expended:
 - (i) to purchase qualifying stock in a Utah small business corporation; and

- (ii) within a 12-month period after the day on which the capital gain transaction occurs; and
- (b) prior to the purchase of the qualifying stock described in Subsection (3)(a)(i), the claimant, estate, or trust did not have an ownership interest in the Utah small business corporation that issued the qualifying stock.
- (4) A claimant, estate, or trust may not carry forward or carry back a tax credit under this section.
- (5) In accordance with Title 63G, Chapter 3, Utah Administrative Rulemaking Act, the commission may make rules:
 - (a) defining the term "gross proceeds"; and
 - (b) prescribing the circumstances under which a claimant, estate, or trust has an ownership interest in a Utah small business corporation.

Subsections (1)(c) and (1)(e) of § 59-10-1022 define long-term and short-term capital gains as the same as for IRC § 1222, with IRC § 1222 stating the following:

- (1) Short-term capital gain
The term “short-term capital gain” means gain from the sale or exchange of a capital asset held for not more than 1 year, if and to the extent such gain is taken into account in computing gross income.
....
- (3) Long-term capital gain
The term “long-term capital gain” means gain from the sale or exchange of a capital asset held for more than 1 year, if and to the extent such gain is taken into account in computing gross income.
....

Subsection (1)(f) of § 59-10-1022 defines Utah small business corporation in terms of IRC § 1244(c). IRC § 1244(c) as modified according to § 59-10-1022(1)(f) is as follows:

Section 1244 stock defined

- (1) In general
For purposes of this section, the term “section 1244 stock” means stock in a domestic corporation if-
 - (A) at the time such stock is issued, such corporation was a small business corporation,
 - (B) such stock was issued by such corporation for money or other property (other than stock and securities), and
 - (C) such corporation, during the period of its 5 most recent taxable years ending before **[the last day of the taxable year for which the claimant, estate, or trust claims a tax credit under this section]**, derived more than 50 percent of its aggregate gross receipts from sources other than royalties, rents, dividends, interests, annuities, and sales or exchanges of stocks or securities.
- (2) Rules for application of paragraph (1)(C)
 - (A) Period taken into account with respect to new corporations

For purposes of paragraph (1)(C), if the corporation has not been in existence for 5 taxable years ending before **[the last day of the taxable year for which the claimant, estate, or trust claims a tax credit under this section]**, there shall be substituted for such 5-year period—

- (i) the period of the corporation's taxable years ending before such date, or
- (ii) if the corporation has not been in existence for 1 taxable year ending before such date, the period such corporation has been in existence before such date.

(B) Gross receipts from sales of securities

For purposes of paragraph (1)(C), gross receipts from the sales or exchanges of stock or securities shall be taken into account only to the extent of gains therefrom.

(C) Nonapplication where deductions exceed gross income

Paragraph (1)(C) shall not apply with respect to any corporation if, for the period taken into account for purposes of paragraph (1)(C), the amount of the deductions allowed by this chapter (other than by sections 172, 243, 244, and 245) exceeds the amount of gross income.

(3) Small business corporation defined

(A) In general

For purposes of this section, a corporation shall be treated as a small business corporation if the aggregate amount of money and other property received by the corporation for stock, as a contribution to capital, and as paid-in surplus, does not exceed **[\$2,500,000]**. The determination under the preceding sentence shall be made as of the time of the issuance of the stock in question but shall include amounts received for such stock and for all stock theretofore issued.

(B) Amount taken into account with respect to property

For purposes of subparagraph (A), the amount taken into account with respect to any property other than money shall be the amount equal to the adjusted basis to the corporation of such property for determining gain, reduced by any liability to which the property was subject or which was assumed by the corporation. The determination under the preceding sentence shall be made as of the time the property was received by the corporation.

(Modified language inserted above from § 59-10-1022(1)(f) has been bracketed and emphasized.)

Subsection (1)(d) of § 59-10-1022, defining qualifying stock, uses the term “partnership.” The definitions of partnership and corporation are found in Utah Code § 59-10-103(b) and (o), which state the following in part:

(b) “Corporation” includes:

- (i) an association;
- (ii) a joint stock company; and

(iii) an insurance company.

.....
(o) (i) "Partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization:

.....
(B) which is not, within the meaning of this chapter:

- (I) a trust;
- (II) an estate; or
- (III) a corporation.

(ii) "Partnership" does not include any organization not included under the definition of "partnership" in Section 761, Internal Revenue Code.

.....

Subsection (1)(d) of § 59-10-1022 also uses the term "claimant." For purposes of the Credit and the other nonrefundable credits found in the Utah Individual Income Tax Act, Utah Code § 59-10-1002(1) defines claimant as follows:

- (a) Except as provided in Subsection (1)(b) or Subsection 59-10-1003(2), "claimant" means a resident or nonresident person that has state taxable income.
- (b) "Claimant" does not include an estate or trust.

The above definition of claimant uses the term "state taxable income." Utah Code § 59-10-103(1) defines state taxable income and the related terms of individual, resident individual, and nonresident individual, as follows in pertinent part:

(j) "Individual" means a natural person and includes aliens and minors.

.....

(m) "Nonresident individual" means an individual who is not a resident of this state.

.....

(q) (i) "Resident individual" means:

(A) an individual who is domiciled in this state . . . or

(B) an individual who is not domiciled in this state but:

- (I) maintains a place of abode . . . and
- (II) spends in the aggregate 183 or more days of the taxable year in this state.

.....

(w) "Taxable income" or "state taxable income":

- (i) subject to Section 59-10-1404.5,^[1] for a resident individual, means the resident individual's adjusted gross income after making the:

¹ Utah Code § 59-10-1404.5, available at http://le.utah.gov/code/TITLE59/htm/59_10_140405.htm, explains in part that when a resident pass-through entity taxpayer receives a pass through of an item of income, gain, loss, deduction, or credit that is not taken into account separately for federal income tax purposes, the item is calculated based on a taxpayer's pro rata share of the item if the pass-through entity is an S corporation or based on a taxpayer's distributive share of an item if the pass-through entity is not an S corporation.

- (A) additions and subtractions required by Section 59-10-114; and
- (B) adjustments required by Section 59-10-115;
- (ii) for a nonresident individual, is an amount calculated by:
 - (A) determining the nonresident individual's adjusted gross income for the taxable year, after making the:
 - (I) additions and subtractions required by Section 59-10-114; and
 - (II) adjustments required by Section 59-10-115; and
 - (B) calculating the portion of the amount determined under Subsection (1)(w)(ii)(A) that is derived from Utah sources in accordance with Section 59-10-117;
- (iii) for a resident estate or trust, is as calculated under Section 59-10-201.1; and
- (iv) for a nonresident estate or trust, is as calculated under Section 59-10-204.

(Footnote 1 added to § 59-10-103(1)(w)(i).)

The definition for claimant found in Utah Code § 59-10-1002(1) uses the term “person.” Utah Code § 68-3-12.5(16) defines person for the Utah Code as follows:

"Person" means:

- (a) an individual;
- (b) an association;
- (c) an institution;
- (d) a corporation;
- (e) a company;
- (f) a trust;
- (g) a limited liability company;
- (h) a partnership;
- (i) a political subdivision;
- (j) a government office, department, division, bureau, or other body of government; and
- (k) any other organization or entity.

Utah Code, Title 59, Chapter 10, Part 14 is the Pass-Through Entity Taxpayers Act. Utah Code § 59-10-1402 defines pass-through entity and pass-through entity taxpayer as follows in part:

- (10) "Pass-through entity" means a business entity that is:
 - (a) the following if classified as a partnership for federal income tax purposes:
 - (i) a general partnership;
 - (ii) a limited liability company;
 - (iii) a limited liability partnership; or
 - (iv) a limited partnership;
 - (b) an S corporation;

- (c) an estate or trust with respect to which the estate's or trust's income, gain, loss, deduction, or credit is divided among and passed through to one or more pass-through entity taxpayers; or
 - (d) a business entity similar to Subsections (10)(a) through (c):
 - (i) with respect to which the business entity's income, gain, loss, deduction, or credit is divided among and passed through to one or more pass-through entity taxpayers; and
 - (ii) as defined by the commission by rule made in accordance with Title 63G, Chapter 3, Utah Administrative Rulemaking Act.
- (11) "Pass-through entity taxpayer" means a resident or nonresident individual, a resident or nonresident business entity, or a resident or nonresident estate or trust:
- (a) that is:
 - (i) for a general partnership, a partner;
 - (ii) for a limited liability company, a member;
 - (iii) for a limited liability partnership, a partner;
 - (iv) for a limited partnership, a partner;
 - (v) for an S corporation, a shareholder;
 - (vi) for an estate or trust described in Subsection (10)(c), a beneficiary;
 - or
 - (vii) for a business entity described in Subsection (10)(d), a member, partner, shareholder, or other title designated by the commission by rule made in accordance with Title 63G, Chapter 3, Utah Administrative Rulemaking Act; and
 - (b) to which the income, gain, loss, deduction, or credit of a pass-through entity is passed through.

Utah Code § 59-10-1403 states the following for items passed through to pass-through entity taxpayers:

- (1) Subject to Subsection (3), a pass-through entity is not subject to a tax imposed by this chapter.
- (2) The income, gain, loss, deduction, or credit of a pass-through entity shall be passed through to one or more pass-through entity taxpayers as provided in this part.
- (3) A pass-through entity is subject to the return filing requirements of Section 59-10-507.
- (4) A pass-through entity that transacts business in the state shall be classified for purposes of taxation under this title in the same manner as the pass-through entity is classified for federal income tax purposes.

Furthermore, Utah Code § 59-10-1404 states the following for items passed through.

Regardless of whether or how an item of income, gain, loss, deduction, or credit is characterized for federal income tax purposes, that item of income, gain, loss, deduction, or credit is from the same source and incurred in the same manner for a

pass-through entity taxpayer as if the item of income, gain, loss, deduction, or credit is:

- (1) realized directly from the source from which the item of income, gain, loss, deduction, or credit is realized by the pass-through entity; or
- (2) incurred in the same manner as incurred by the pass-through entity.

Utah Code § 59-1-1406 imposes recordkeeping requirements on taxpayers as follows:

- (1) A person subject to a tax, fee, or charge shall:
 - (a) keep in a form prescribed by the commission books and records that are necessary to determine the amount of a tax, fee, or charge the person owes;
 - (b) keep books and records described in Subsection (1)(a) for the time period during which an assessment may be made under Section 59-1-1408; and
 - (c) open the person's books and records for examination at any time by:
 - (i) the commission; or
 - (ii) an agent or representative the commission designates.

....

- (3) For the purpose of ascertaining the correctness of a return or for estimating a tax, fee, or charge due in accordance with Subsection (2)(a), the commission may:
 - (a) examine the books and records bearing upon the matter required to be included in a return;
 - (b) authorize an agent or representative designated by the commission to examine the books and records bearing upon the matter required to be included in a return;
 - (c) require the attendance of:
 - (i) an officer or employee of a person required to make a return; or
 - (ii) a person having knowledge of a pertinent fact;
 - (d) take testimony; or
 - (e) require any other necessary information.

Utah Administrative Code R865-9I-18 also imposes a recordkeeping requirement on taxpayers and states the following:

- (1) Every taxpayer shall keep adequate records for income tax purposes of a type which clearly reflect income and expense, gain or loss, and all transactions necessary in the conduct of business activities.
- (2) Records of all transactions affecting income or expense, or gain or loss, and of all transactions for which deductions may be claimed, should be preserved by the taxpayer to enable preparation of returns correctly and to substantiate claims. All records shall be made available to an authorized agent of the commission when requested, for review or audit.

Utah Code § 68-3-12 contains rules of construction, including subsection (1)'s instruction for singular and plural terms, which is as follows:

- (a) In the construction of a statute in the Utah Code, the general rules listed in this Subsection (1) shall be observed, unless the construction would be:
 - (i) inconsistent with the manifest intent of the Legislature; or
 - (ii) repugnant to the context of the statute.
- (b) The singular includes the plural, and the plural includes the singular.

....

Case law provides the well recognized principle of law that tax statutes providing exemptions or credits generally are interpreted narrowly and strictly construed against the taxpayer. *See Parson Asphalt Prods., Inc. v. State Tax Comm'n*, 617 P.2d 397, 398 (Utah 1980) (“[s]tatutes which provide for exemptions should be strictly construed, and one who so claims has the burden of showing his entitlement to the exemption”). Tax credit statutes, like tax exemptions, “are to be strictly construed against the taxpayer.” *MacFarlane v. State Tax Comm'n*, 2006 UT 18, ¶11. However, in *MacFarlane*, the Court did explain, “While we recognize the general rule that statutes granting credits must be strictly construed against the taxpayer, the construction must not defeat the purposes of the statute. The best evidence of that intent is the plain language of the statute.” (Citations omitted.) *See id.* at ¶19.

II. Analysis

This analysis contains a general explanation of the Credit followed by analyses and conclusions for your four specific questions.

A. General Explanation of the Credit

The Credit is located in Utah Code § 59-10-1022. Subsection (2) of § 59-10-1022 grants a claimant, estate, or trust a Credit equal to 5% of the claimant's, estate's, or trust's capital gain on a capital gain transaction occurring on or after January 1, 2008 if the claimant, estate, or trust meets certain requirements found in subsection (3) of § 59-10-1022.

A capital gain transaction includes an act or instance of conducting business resulting in a gain from the sale or exchange of a capital asset if and to the extent such gain is taken into account in computing gross income for federal purposes. The preceding statement is based on multiple statutes. A capital gain transaction is defined in § 59-10-1022(1)(a) as a transaction resulting in a short-term or long-term capital gain. Under § 59-10-1022(1)(c), (e), short-term and long-term capital gains have the same meanings as they do for federal purposes under the Internal Revenue Code. Under IRC § 1222(1) and (3), a short-term or long-term capital gain means “gain from the sale or exchange of a capital asset if and to the extent such gain . . . is taken into account in computing gross income” for federal purposes. “Transaction” as used in the definition of capital gain transaction is not defined by statute or rule. The legal definition found in the *Black's Law Dictionary* is as follows in part: “1. The act or an instance of conducting business or other dealings; esp., the formation, performance, or discharge of a contract. 2.

Something performed or carried out; a business agreement or exchange. 3. Any activity involving two or more persons. . . .” *Id.* at 1635 (9th ed. 2009).

For purposes of the Credit, a claimant must be a natural person. This statement is also based on multiple statutes. Section 59-10-1002(1) defines “claimant” for purposes of the non-refundable tax credits found in Title 59, Chapter 10, Part 10, which area of the code includes the capital gain transaction credit. Under § 59-10-1002(1), a claimant is a resident or nonresident person *who has state taxable income* and who is not an estate or trust. Section 59-10-103(1)(w) defines state taxable income. Under that section only the following people have state taxable income: a “resident individual,” a “nonresident individual,” a “resident estate or trust,” and a “nonresident estate or trust.” For resident and nonresident individuals, § 59-10-103(1)(j) defines “individual” as a natural person including aliens and minors. Pass-through entities do not have state taxable income under Chapter 10. Pass-through entities include entities such as partnerships, limited liability companies, and S corporations. § 59-10-1402(10) (defining pass-through entity). Section 59-10-1403(1) states that pass-through entities are “not subject to a tax imposed by this chapter [Title 59 Chapter 10].” Thus, pass-through entities cannot be claimants for purposes of the non-refundable tax credits found in Part 10. However, a pass-through entity can pass-through items of a credit, which might allow a claimant to qualify for and claim a credit that a pass-through entity cannot qualify for or claim directly. The Pass-Through Entities and Pass-Through Entity Taxpayers Act found in § 59-10-1401 et seq. directs how items of income, gain, loss, deduction, or credits are passed through.

For a claimant, estate, or trust to qualify for the Credit, 70% or more of the gross proceeds of a capital gain transaction must be expended to purchase qualifying stock in a Utah small business corporation. § 59-10-1022(3)(a)(i). Under § 59-10-1022(1)(d)(i) and (ii), qualifying stock is common or preferred stock that is originally issued to the claimant, estate, or trust or to a partnership if the claimant, estate, or trust was a partner on the day the stock was issued and remained a partner through the last day of the taxable year for which the claimant, estate, or trust takes the Credit. Under § 59-10-103(o), a partnership is not a corporation. Furthermore to be qualifying stock, under § 59-10-1022(1)(d)(iii), the stock must be issued by a Utah small business corporation on or after January 1, 2008 for money or other property except for stock or securities. Under § 59-10-1022(1)(f) and IRC § 1244(c)(3), a Utah small business corporation is defined as a corporation in which the aggregate amount of money and other property received by the corporation for stock, as a contribution to capital, and as paid-in surplus, does not exceed \$2,500,000. Furthermore under § 59-10-1022(1)(f) and IRC § 1244(c)(1)(C), for the five consecutive years ending before the last day of the taxable year for which the claimant, estate, or trust takes the Credit, the corporation must derive more than 50 percent of its aggregate gross receipts from sources other than royalties, rents, dividends, interests, annuities, and sales or exchanges of stocks or securities for the corporation to be a Utah small business corporation.

Additionally to qualify for the Credit, under § 59-10-1022(3)(a)(ii) the qualifying stock must be purchased within a 12-month time period starting when the capital gain transaction occurs, and under § 59-10-1022(3)(b), the claimant, estate, or trust must not have had an ownership interest in the Utah small business corporation that issued the qualifying stock before the claimant, estate, or trust purchased that stock.

B. Responses to Your Questions

Below are your four questions as you stated them followed by the Commission's responses.

Question 1

Your question is as follows:

The language in Utah Code §59-10-1022 does not expressly include S corporations. However, page 15 of the instructions for Form TC-20S lists the capital gain transactions credit as code 04 under nonrefundable credits and explicitly states that an S corporation "may claim a credit for the short-term and long-term capital gain on a transaction if" certain requirements are met. The instructions also direct that "Nonrefundable credits on an S corporation return are entered on Schedule K and then allocated and passed-through to the shareholders on Schedule K-1." Are S corporations eligible to generate a capital gain transactions tax credit and pass that credit on to their shareholders?

In response to your question, an S Corporation cannot generate the Utah capital gain transaction credit and pass it through to its shareholders. The *2012 Form TC-20S Instructions* (for S corporations) contain incorrect information about the Credit on page 15.

An S Corporation cannot generate the Credit because it cannot purchase qualifying stock. Section 59-10-1022(1)(d)(ii) prevents qualifying stock from being originally issued to an S corporation; instead, it allows qualifying stock to only be originally issued either to a claimant, estate, or trust, with claimant meaning a natural person, or to a partnership with the claimant, estate, or trust being a partner for the required time period. An S corporation is not a claimant because it is not a natural person. It is also not a partnership. Under § 59-10-103(o), a partnership is not a corporation. Under § 59-10-103(b), a corporation includes an association, joint stock company, and insurance company; thus, an S corporation would be a "corporation" for purposes of the Utah Individual Income Tax Act.

Although an S corporation cannot generate a Credit on its own for the reasons presented above, it can still pass through a Credit generated by a partnership to the extent the S corporation is a partner in that partnership.

Question 2

Your question is as follows:

Assume an S corporation or partnership has a capital gain transaction and then distributes the proceeds from the capital gain transaction to its shareholders or partners. If the shareholders or partners reinvest the proceeds in a Utah small business corporation would they be eligible to receive a tax credit for capital gain transactions since the capital gain is passed through to them from the S

corporation or partnership? If so, would all shareholders and partners be required to reinvest at least 70% of the proceeds as a group, or would each taxpayer be eligible for the credit on an individual basis without regard to the actions of the other shareholders or partners?

In response, the Commission concludes that an individual who is a shareholder or a partner could qualify for the Credit when an S corporation or partnership has the capital gain transaction and the shareholder or partner expends the gross proceeds of that transaction on qualifying stock. Under § 59-10-1404, “[an] item of income, gain, loss, deduction, or credit is from the same source and incurred in the same manner for a pass-through entity taxpayer as if the item of income, gain, loss, deduction, or credit is: (1) realized directly from the source from which the item of income, gain, loss, deduction, or credit is realized by the pass-through entity; or (2) incurred in the same manner as incurred by the pass-through entity.” Thus, for the capital gain transaction realized by an S corporation or partnership, the individual shareholders or partners will treat their portion of the capital gain transaction as having been realized from the same source and incurred in the same manner as the S corporation or partnership.

The eligibility for the Credit is determined on an individual basis, without regard to the actions of the other shareholders or partners. You have asked the Commission to interpret one of the requirements for the Credit. Under § 59-10-1022(3)(a)(i), “70% or more of the gross proceeds of the capital gain transaction” must be expended to purchase qualifying stock. The Commission interprets the capital gain transaction for a shareholder or partner to be only the shareholder’s or partner’s portion of the gross proceeds received by the S corporation or partnership. A shareholder or partner must reinvest 70% for more of his or her portion of the gross proceeds to meet the requirement found in § 59-10-1022(3)(a)(i).

As a reminder, a shareholder or partner would need to meet the requirement found in § 59-10-1022(3)(a)(i) and all other requirements found in § 59-10-1022 to qualify for the Credit. For the situation present, the requirement found in § 59-10-1022(3)(a)(ii) is notable. This section requires the qualifying stock to be purchased within a 12-month time period starting when the capital gain transaction occurs. A claimant who is a shareholder or partner must meet this 12-month requirement based on when the S corporation or partnership engages in the capital gain transaction, not when the S corporation or partnership reports the capital gain transaction to the shareholders or partners, possibly through a Schedule K-1 or other means.

Furthermore, a shareholder or partner claiming the Credit is required to keep records showing he or she meets all of the Credit’s requirements. The Tax Commission has no duty to compile information from the S corporation or partnership to verify that any of the requirements have been met.

Question 3

Your question is as follows:

Lastly, how do installment sale rules work in relation to the capital gain transaction credit? In order to qualify for a tax credit for capital gain transactions

from an installment sale, is a taxpayer required to reinvest at least 70% of the total proceeds to be received in all future years, or are they only required to reinvest at least 70% of the proceeds received from any one installment?

In response, in the installment sale context, a claimant must expend 70% or more of the gross proceeds of the installment sale transaction within 12-months after entering into the installment sale contract. The gross proceeds would include the monetary value of the items received by the seller at the time of the parties enter the installment sale contract. The gross proceeds would not be reduced for transaction costs, such as expenses and commissions. Also, for an installment sale, gross proceeds would not include the interest portion of future installment payments.

A 12-month reinvestment time period is provided in § 59-10-1022(3)(a)(ii), under which a claimant must expend 70% or more of gross proceeds “within a 12-month period after the day on which the *capital gain transaction* occurs . . .” (emphasis added). Under § 59-10-1022(1)(a)(i), a capital gain transaction “means a *transaction* that results in a . . . capital gain” (emphasis added). The Commission interprets “capital gain transaction” as occurring only once for an installment sale, when the parties enter into the installment sale contract. Thus, to qualify for the Credit, a claimant must expend at least 70% of the gross proceeds within the 12-month period after the day the claimant enters into the installment sale contract. A claimant receiving installment payments over a number of years does not meet the requirement found in § 59-10-1022(3)(a)(ii) by only expending 70% of one installment payment on qualifying stock or even by expending 70% of all installment payments on qualifying stock as the payments are received. Thus, a claimant wanting to claim the Credit might need to expend cash on qualifying stock before he or she has received, through installment payments, a cash amount equal to her gross proceeds, as calculated at the time of entering the installment sale contract.

A claimant who meets § 59-10-1022(3)(a)(ii) and the other requirements for the Credit, may claim the Credit over time, as the installment payments are received and the capital gains are recognized for tax purposes. Section 59-10-1022(2) provides that the Credit “equal[s] the product of: (a) the total amount of the claimant’s short-term capital gain or long-term capital gain on a capital gain transaction . . . and (b) 5%.” With an installment sale, the amount of the Credit for each tax year would be the product of the claimant’s short-term capital gain or long-term capital gain recognized for that tax year for the installment sale payments multiplied by 5%. When all installment sale payments have been received, the claimant will have claimed a Credit equal to 5% of the total amount of her capital gain on the installment sale.

Question 4

Your question is as follows:

In the case of a large single capital gain transaction, where it is impossible to reinvest at least 70% of the proceeds in a Utah small business corporation due to the \$2,500,000 equity cap for small businesses, is there any way to receive a prorated amount of tax credit to the extent that the proceeds are reinvested in a Utah small business corporation?

In response, in a large single capital gain transaction, it is possible to expend at least 70% of the gross proceeds to qualify for the Credit by purchasing qualifying stock from Utah small business corporations, instead of just from a single corporation. A proration of the Credit, as proposed by your question, is not allowed.

Subsection (3)(a) of § 59-10-1022 requires “70% or more of the gross proceeds [to be] expended . . . to purchase qualifying stock in a Utah small business corporation . . .” Although the statute uses “a Utah small business corporation” in the singular form, § 68-3-12(1)(a) and (b) instruct that when interpreting the Utah Code, the singular form of a word includes a plural form unless that interpretation would be inconsistent with the manifest intent of the Legislature. The Legislature intended the Credit to encourage new investment in Utah small business corporations. Interpreting subsection (3)(a) to allow 70% or more of the gross proceeds to be invested in Utah small business corporations furthers this legislative intent. Thus, § 68-3-12(1)(b) applies and 70% or more of the gross proceeds can be expended to purchase qualifying stock in Utah small business *corporations*.

III. Conclusions

As explained above, the Commission reached the following four conclusions:

1. S corporations cannot generate or pass through a Utah capital gain transaction credit to their shareholders.

Although an S corporation cannot generate a Credit on its own, it can still pass through a Credit generated by a partnership to the extent the S corporation is a partner in that partnership.

2. A shareholder or a partner could qualify for the Credit when an S corporation or partnership has the capital gain transaction and the shareholder or partner invests the gross proceeds in a Utah small business corporation. The 70% expenditure requirement found in § 59-10-1022(3)(a) and the other requirements for the Credit would be determined on an individual basis.
3. For an installment sale, a claimant is required to reinvest at least 70% of the gross proceeds, with the gross proceeds equaling the value of capital assets (land, investments, etc.) when sold. The 70% requirement is not applied each time an installment payment is received.
4. In a large, single capital gain transaction, it is still possible to reinvest at least 70% of the gross proceeds to qualify for the Credit by purchasing qualifying stock from Utah small business corporations, instead of just from a single corporation. A proration of the tax credit is not allowed.

This private letter ruling is based on current law and could be changed by subsequent legislative action or judicial interpretation. Also, our conclusions are based on the facts as described. If you

feel the Commission has misunderstood the facts as you have presented them, you have additional facts that may be relevant, or you have any other questions, you are welcome to contact the Commission.

For the Commission,

D'Arcy Dixon Pignanelli
Commissioner

DDP/aln
13-004