

State of Rhode Island - Division of Taxation

Tax Credits/Deductions

Regulation CR 01-04

Effective January 1, 1998 the investment tax credit statute (RIGL 44-31) was extended to provide a ten percent (10%) tax credit to manufacturers and certain non-manufacturers ("qualified taxpayers") which meet statutorily defined criteria. The investment tax credit was further extended on June 30, 1999 to provide the ten percent (10%) tax credit to property having a situs in Rhode Island however acquired by "qualified taxpayers" which are property and casualty insurance companies.

This regulation is set out in two (2) parts. The first part of the regulation deals with manufacturers that meet the criteria for the four percent (4%) tax credit. The second part of the regulation deals with manufacturers and non-manufacturers which meet the statutory criteria for the ten percent (10%) tax credit.

In general, provisions applicable to manufacturers in Part I are deemed applicable to "qualified taxpayers" in Part II unless law or regulations in Part II mandate otherwise.

Documentation and Information Required

Taxpayers seeking credit as "manufacturers or qualified taxpayers" must complete the 3468 form and must attach copies of calculations and documents evidencing satisfaction of the special criteria required for "qualified taxpayers" including but not limited to letters documenting training expenses from the Human Resource Investment Council, documenting wage information from the RI Department of Labor and Training, and calculations pertaining to wages or gross revenues.

INVESTMENT TAX CREDIT - PART I "MANUFACTURERS"

I. A taxpayer shall be allowed an investment tax credit computed in accordance with 44-31-1 against the business corporation tax or the personal income tax as imposed by Chapters 44-11 and 44-30, respectively, on tangible personal property and other tangible property, including buildings and structural components of buildings acquired, constructed, reconstructed or erected for use principally by the taxpayer in the production of goods by manufacturing, processing or assembling. The investment tax credit shall be allowed against the business corporation tax computed on the basis of net income or net worth apportioned to Rhode Island, provided, however, that an investment tax credit will be allowed against the tax of only that corporation, included in a consolidated state tax return, that qualifies for the credit and will not be allowed against the tax of other corporations that may join in the filing of a consolidated state tax return with such corporation.

The investment tax credit shall be allowed on qualifying property acquired, constructed,

reconstructed or erected after December 31, 1973 and first placed in service in this state during a taxable year beginning on or after July 1, 1974. A taxpayer placing otherwise qualifying property in service during a taxable year beginning prior to July 1, 1974 shall not be allowed a credit in the year placed in service nor shall the taxpayer be allowed a carryforward to any subsequent year.

In order to qualify for this credit, the property must:

- a. (a) Be depreciable pursuant to Sec. 167 of the Internal Revenue Code;
- b. (b) Have a useful life of 4 years or more;
- c. (c) Be acquired by purchase as defined in Sec. 179(d) of the Internal Revenue Code;
- d. (d) Have a situs in this state at the date first placed in service by the taxpayer; and
- e. (e) Be principally used by the taxpayer in the production of goods by manufacturing, processing or assembling, as hereinafter described.

II. For the purpose of this regulation, the business of manufacturing, processing or assembling, shall be divided into three parts as follows:

- a. Administration, meaning all administrative work such as general office operations, accounting, purchasing, collection, sales promotion, clerical work in production such as preparation of work records, production records and time records, and the transporting of raw materials to the plant.
- b. Production, meaning all operations performed in producing or processing room, shop or plant, including the production line starting with the handling and storage of raw materials at the plant and continuing through the last step of production where the product is finished, packaged for sale and stored. Production shall also include machinery, equipment or other tangible property which is principally used in the repair and service of other machinery, equipment or other tangible property used principally in the production of goods.
- c. Distribution, meaning all operations subsequent to production such as selling, displaying, loading and transporting the manufactured products.

The investment tax credit does apply to property used in the producing or processing room, shop, or plant if such property is principally used in production as defined above. The investment tax credit does not apply to property principally used in administration and distribution as defined above.

III. Section 44-31-1(b) states:

". . . manufacturing shall mean the process of working raw materials into wares suitable for use or which gives new shapes, new quality or new combinations to matter which already has gone through some artificial process by the use of machinery, tools, appliances, and other similar equipment. Property used in the production of goods shall

include machinery, equipment or other tangible property which is principally used in the repair and service of other machinery, equipment or other tangible property used principally in the production of goods and shall include all facilities used in the production operation, including storage of materials to be used in production and of the products that are produced."

Within the meaning of the preceding paragraph a taxpayer is deemed to be a manufacturer within a city or town within this state if it uses any premises, room or place therein primarily for the purpose of transforming raw materials into a finished product for trade through any or all of the following operations: adapting, altering, finishing, making and ornamenting; provided, however, that public utilities, building and construction contractors, warehousing operations, including distribution bases or outlets of out-of-state manufacturers, fabricating processes incidental to warehousing or distribution of raw materials such as alteration of stock for the convenience of a customer, shall be excluded from this definition.

A manufacturer is a taxpayer whose principal business in this state consists of transforming raw materials into a finished product for trade through any or all of the operations described in the preceding paragraph. A taxpayer will be deemed to be thus principally engaged if the gross receipts derived from such manufacturing operations in this state during the taxable year amounted to more than fifty percent (50%) of the total gross receipts derived from all the taxpayer's business activities in this state during the same taxable year. For the purpose of computing this percentage, gross receipts derived by a manufacturer from the sale, lease or rental of finished products manufactured by the taxpayer in Rhode Island should be deemed to have been from manufacturing even though the taxpayer's store or other sales place in Rhode Island may be at a different Rhode Island location from the Rhode Island manufacturing plant.

The term "manufacturer" shall also include taxpayers who are principally engaged in any of the general activities respectively coded and listed as establishments engaged in manufacturing in the Standard Industrial Classification Manual prepared by the Technical Committee on Industrial Classification, Office of Statistical Standards, Executive Office of the President, United States Bureau of the Budget, as revised from time to time, but eliminating as manufacturers those taxpayers, who, because of their limited type of manufacturing activities, are classified in the manual as falling within a trade rather than an industrial classification of manufacturers. Among those thus eliminated (and accordingly also excluded as manufacturers within the meaning of this subsection), are taxpayers primarily engaged in selling, to the general public products produced on the same premises from which they are sold, such as neighborhood bakeries, candy stores, ice cream parlors, shade shops and custom tailors. However, a person who manufactures bakery products for sale primarily for home delivery, or through one or more nonbaking retail outlets (whether or not the retail outlets are operated by the taxpayer) shall be a manufacturer.

IV. The credit is 2% of the cost or other basis for federal tax purposes and is only allowable in the year the property is first placed in service by the taxpayer for the production of goods by manufacturing, processing or assembling provided, however, that only the portion of expenditures that is properly attributable to acquisition, construction, reconstruction or erection after December 31, 1973 is taken into account, provided however the amount of credit shall be 4% of the cost or other basis for federal tax purposes for expenditures after December 31, 1993. If property is principally used in manufacturing, processing or assembling and is partially rented

or leased, etc., the basis of the property must be adjusted for that proportionate share of nonqualifying use. Property is considered first placed in service by the taxpayer in the tax year in which under the taxpayer's depreciation practice, the period for depreciation for the property begins or the year in which the property is placed in a condition or state of readiness and availability for a specifically assigned function, whichever is earlier. If, for the federal tax purposes of the taxpayer, qualifying property has a useful life of a range of three to five years, such property will be considered to have a useful life of four years. The credit may not reduce the tax for any year to less than the minimum tax. Any unused investment tax credit may be carried forward for seven years.

V. "Principally used" means used more than 50%. A building or addition is principally used in production where more than 50% of its useable business floor space is used in storage and production. Floor space used for bathrooms, cafeterias and lounges is not useable business floor space. Floor space used for administration and distribution is not used in production. Machinery is principally used in production when it is used in production more than 50% of its normal operating time.

EXAMPLE: ABC Corp., a calendar year corporation, acquires a five story building, including structural components, (each story of equal square footage) on 1/1/75, the basis of which is \$100,000.

- a. Taxpayer rents or leases out three floors and uses the remaining two floors in the production of goods by manufacturing, processing or assembling.
Since less than 50% of the building is used in production, there is no investment tax credit allowed on any portion of the building.
- b. Taxpayer rents or leases out two floors and uses the remaining three floors in the production of goods by manufacturing, processing or assembling.
Since more than 50% of the building is used in production, there will be allowed an investment tax credit on that portion of the building not leased.
- c. Taxpayer uses three floors for production and two floors for administration and distribution.
Since more than 50% of the building is used in production and none of the building is leased out, there will be allowed an investment credit on the whole building.

VI. A taxpayer shall not be allowed a credit with respect to tangible personal property and other tangible property, including buildings and structural components of buildings, which it leases to any other person or corporation or leases from any other person or corporation. For purposes of the preceding sentence, any contract or agreement to lease or rent or for a license to use such property shall be considered a lease, unless such contract or agreement is treated for federal income tax purposes as an installment purchase rather than a lease. In order to be considered the owner of the production property, a taxpayer must be allowed federal depreciation on such property. Since property rented to others does not qualify for credit, the credit shall not be allowed where the purchaser is not the user of production property, even where the purchaser and the user may be included in a consolidated federal and/or a consolidated state tax return.

VII. At the election of the taxpayer, an investment credit may be allowed on otherwise qualifying

property in lieu of elective deductions on facilities qualifying as:

- a. Air and water pollution control facilities (Sec. 44-11-11(a) and 44-30-7);
- b. Research and development facilities (Sec. 44-32-1).

The election may be made even though the qualifying property is not depreciable under Sec. 167 of the Internal Revenue Code and is amortized under Sec. 169 or 174 of the Internal Revenue Code.

Where amortization of air and water pollution control facilities was deducted from apportioned net income or where expenditures for research and development facilities were deducted from allocated entire net income, an investment tax credit will not be allowed on the same facilities.

VIII. A recapture of a portion of the investment tax credit is required where property on which a credit has been allowed is disposed or ceases to be in qualified use except:

- a. Where property was in qualified use for its entire useful life, or
- b. Where property was in qualified use for more than twelve consecutive years.

IX. Computation of the recapture.

$$\text{Recapture} = \text{Tax credit taken on property ceasing to qualify} \times \frac{(\text{useful life of property in months} - \text{qualified use in months})}{(\text{useful life of property in months})}$$

EXAMPLE: XYZ Corp., a calendar year corporation, acquires a five story building, including structural components, (each story of equal square footage) on January 1, 1975, and the building's basis is \$100,000. The building has a 20 year life. Taxpayer rents or leases out one floor and uses the remaining four floors as three in production and one in administration and distribution. Investment Tax Credit = $2\% \times (\$100,000 - \$20,000) = \$1,600$.

- a. On January 1, 1976 taxpayer rents another floor that it had previously been using in administration and distribution. At that point taxpayer is renting two floors and using the remaining three floors in production.

Computation of the recapture would be as follows:

$$R = \$1,600 \times \frac{1}{4} (240 \text{ months} - 12 \text{ months})$$

240 months

$$R = \$400 \times 95\%$$

$$R = \$380$$

- b. On January 1, 1976 taxpayer rents two more floors used in production before. At this point the taxpayer is renting three floors and using the remaining two floors as one in

production and one in administration and distribution. Since the entire building is not used more than 50% in production, there is a recapture of the entire remaining investment credit computed as follows:

$$R = \$1,600 \times \frac{4}{4} \left(\frac{240 \text{ months} - 12 \text{ months}}{240 \text{ months}} \right)$$

$$R = \$1,600 \times 95\%$$

$$R = \$1,510$$

- c. On February 1, 1987 taxpayer converts the entire building to leased property. Since the building was held more than twelve years, there is no recapture of investment tax credit.

X. Where property is disposed of or ceased to be in qualified use during the initial taxable year, the tax credit on that property should be reduced by the recapture on that property.

XI. Where property is disposed of or ceases to be in qualified use during other than the initial taxable year, the taxpayer may not reduce the amount of tax liability created by a recapture of investment tax credits by investment tax credits allowed for the year in which the asset is disposed of, nor can that liability be reduced by any carryovers of investment tax credits to that year. The amount of recapture shall be added to the taxpayer's tax in that year. The amount of recapture required to be added to the tax in that year may not be offset or reduced by application of any other credit otherwise available to the taxpayer for the same tax year. For example, a taxpayer may not offset a recapture of investment credit by applying daycare credits.

XII. The following rules apply to transactions between taxpayers:

A recapture of investment tax credit is required unless all of the following elements are present in the transaction:

- a. The property is transferred from one taxpayer to another by a transaction in which the basis of the property in the hands of the transferee is determined in whole or in part by reference to the basis in the hands of the transferor, or a mere change in the form of the taxpayer's business, and
- b. the acquiring taxpayer is taxable under Chapters 44-11 or 44-30 of the Rhode Island General Laws, and
- c. the property continues to be in qualified use.

If all of the preceding elements are present in the transaction, the transfer will not require a recapture of investment tax credit and any unused investment tax credit on the transferred property may be passed through to and carried forward by the acquiring taxpayer.

If the property in the hands of the acquiring taxpayer is not in qualified use for its entire life or for more than twelve years, a recapture by the acquiring taxpayer is required. In measuring the period of qualified use, the period during which the property was held by the transferor taxpayer and the acquiring taxpayer shall be taken into account.

The above rules do not strictly conform to federal treatment. For example, a recapture is required where a transfer is made other than to an acquiring taxpayer taxable under Chapters 44-11 or 44-30 (on the theory that the property is no longer in qualified use).

XIII. The following are examples of incidents which require recapture:

- a. A legal dissolution;
- b. (b) A trade-in;
- c. (c) Foreclosure of a security interest;
- d. (d) Retirement before expiration of its useful life.
- e. (e) Destruction or damage by fire, storm or other casualty or by reason of its theft or other involuntary conversion;
- f. (f) Where property is leased to others;
- g. (g) Removal of property from the state;
- h. (h) Cease to own property;
- i. (i) Cease to otherwise be in qualified use.

XIV. In order to qualify as property used in the production of goods, inventoriable goods must be produced and the property must be used principally in the production of such goods. Since the law includes property and equipment used to store raw materials and finished goods in the definition of manufacturing, property and equipment at the raw material warehouse and at the finished goods warehouse would qualify provided that the property and equipment are principally used in handling or storing the raw materials or finished goods. Property used to transport raw materials to the raw materials warehouse or finished goods to customers would not qualify. Property used for in-plant handling of materials during the manufacturing process would qualify. Property used for transporting materials between plants over public roads would not qualify.

XV. The investment tax credit shall apply only in the taxable year in which the property is first placed in service by the taxpayer. Acquisitions in a taxable year do not affect similar property previously qualifying. For example, a manufacturer builds an addition to a previously qualifying building for use as office space. The investment in the addition will not qualify for the credit since it is not used in production, but it will not trigger a recapture of the credit taken on the previously existing plant. If the addition was built for use principally in production, the credit would apply.

XVI. The term "taxpayer" as used in the regulation shall mean and include, as appropriate, an individual, a partnership, a corporation, or other taxable entity.

XVII. "Structural components" means such separately attached parts of a building, as walls and

built-in partitions, permanent paneling and tiling, doors, stairways, the entire central heating, plumbing, electrical, and air conditioning systems. Sink and toilet facilities, sprinkler systems, fire escapes, elevators and escalators do not qualify. For the purpose of this regulation, the building and all of its structural components are treated as a whole when the building is acquired, constructed, reconstructed or erected and first placed in service. The repairs, alterations, improvements or replacement of a structural component subsequent to the acquisition, construction, reconstruction or erection of the building will not be allowed the credit.

XVIII. For the purpose of determining the basis of qualifying property, the carryover of investment tax credit and of the recapture of the investment tax credit, pertinent portions of the Internal Revenue Code and regulations thereunder, including provisions applicable to corporations, Subchapter S corporations, estates and trusts, and partnerships are deemed adopted to the extent not inconsistent with this regulation and Rhode Island law.

INVESTMENT TAX CREDIT - PART II - "QUALIFIED TAXPAYER(S)"

I. Generally

A "qualified taxpayer" shall be allowed a credit computed in accordance with section 44-31-1 against the tax imposed by chapters 11, 14, 17 and 30 of this title. The amount of the credit shall be ten percent (10%) of the cost or other basis for Federal income tax purposes, and the qualified amounts for leased assets of tangible personal property and other tangible property acquired, constructed, reconstructed or erected on or after January 1, 1998, and provided, further, however, beginning on or after July 13, 2000 that there shall be allowed a credit in the amount of twenty-five percent (25%) for investments otherwise qualifying under chapter 44-31 for a film production business meeting the following criteria: (1) located within the State of Rhode Island; ; (2) whose primary location for the film production are within the State of Rhode Island; and (3) whose total production budget is a minimum of three hundred thousand dollars (\$300,000) but does not exceed five million dollars (\$5,000,000). Film production shall be defined as the creation of a film documentary, direct-to-video or independent television production sold to commercial distribution. Total production budget shall be defined as a pre-production cost including, but not limited to, the purchase of the screen play, salaries, equipment, film processing, sound, editing, and other services related to production. The budget shall not include costs associated with the promotion or marketing of the film, video or television product. Any cost overruns on the project shall also not be included in the total production budget. The Providence Film Commission, in conjunction with the Rhode Island Film Office and the Rhode Island State Council on the Arts, will establish specific guidelines together with a certification process that will guide the selection and evaluation of film projects that are eligible for investment tax credits.

A "qualified taxpayer" means a taxpayer in any of the businesses described in the major groups 20 through 39, 50 and 51, 60 through 67, 73, 76, 80 through 82, 87 and 89 of the SIC Code (or the corresponding industry sectors of the North American Industry Classification System ["NAICS"]) and/or any of the businesses described in the three (3) digit SIC Code 781 (or the corresponding industry sector of the NAICS) which meet certain wage criteria and with respect to the major groups set forth in section 44-31-1(b)(3)(d)(2) the additional requirement relating to

gross revenues.

II. Leased Property

A. Property leased to the "qualified taxpayer"

To the extent otherwise allowable, the credit shall be allowed for computers, software and telecommunications hardware used by a "qualified taxpayer" even if the property has a useful life of less than four (4) years.

The credit for property acquired by lease shall be based on the fair market value of the property at the inception of the lease times the portion of the depreciable life of the property represented by the term of the lease excluding renewal options.

Example:

Taxpayer X leased a computer from a lessor for a two (2) year period with a useful life of four (4) years. The resulting qualified cost would be a fraction which represents the two (2) year lease divided by the four (4) year life resulting in a fifty percent (50%) qualified cost.

$$\begin{array}{rcll} \text{Lease Period} & 2 \text{ years} & & \\ \text{-----} & = & \text{-----} & = 50\% \times \$20,000 = \$10,000 \\ \text{Life of Asset} & 4 \text{ years} & & \text{(Cost) (Basis)} \end{array}$$

B. Property leased from the "qualified taxpayer" by others

Property leased (subleased or rented) from the "qualified taxpayer" to others does not qualify for the credit.

III. Limitation of Credit

The credit allowed under this subdivision of any taxable year shall not reduce the tax for the year by more than fifty percent (50%) of the tax liability that would otherwise be payable, and further cannot reduce the tax to less than the minimum tax as applicable. However, if the amount of credit allowable under this subdivision of any taxable year is less than the amount of credit available to the taxpayer any amount of credit not deductible in the taxable year may be carried over to the following year or years (not to exceed seven (7) years) and may be deducted from the taxpayer's tax for the year or years.

The "tax liability that would otherwise be payable" is defined as tax after any other credits are applied unless such credits' laws or regulations mandate otherwise.

An example depicting the limitation of fifty percent (50%) of the tax liability is shown below:

A "qualified taxpayer", XYZ Corporation purchases equipment with qualifying costs of \$100,000 on February 1, 1998; has investment tax credit of \$10,000 (10% of \$100,000); and a normal tax year of December 31, 1998. The tax as reported on Line 13 of the RI 1120 is \$30,000. The taxpayer has other credits for enterprise zone wages of \$25,000 and a credit for daycare

assistance of \$3,000. What is the maximum amount of credit that can be taken for ITC?

Tax	\$ 30,000
Enterprise Zone Wage Credit	(25,000)
Daycare Assistance Credit	(3,000)

Tax "Otherwise Payable"	\$ 2,000
Maximum Investment Credit	
50% tax "Otherwise Payable"	
50% x \$2,000 =	1,000

TAX DUE	\$ 1,000

The amount of ITC carryforward is $\$100,000 \times 10\% = \$10,000$ less the amount used of \$1,000, leaving a balance of \$9,000 to be carried forward to 1999.

Only the investment credit allowed and claimed at the ten percent (10%) rate (effective on or after January 1, 1998) is limited to fifty percent (50%) of the tax liability.

Taxpayers are allowed to use one hundred percent (100%) of the credit carried forward from years prior to January 1, 1998 and one hundred percent (100%) of the credit claimed at the four percent (4%) rate on or after January 1, 1998 to the extent of the tax or minimum filing fee.

Example 1:

ABC Jewelry is a "C Corporation"; files and pays business corporation tax (RIGL 44-11); and, for calendar year 1998, has a tax of \$2,750. ABC Jewelry also has an investment credit carry forward of \$4,000 from 1996. Because ABC's investment credit is carried forward from a year prior to January 1, 1998, it can use \$2,500 of the credit to reduce its tax to the minimum filing fee. This is calculated as:

Tax	\$2,750
Minimum Fee	250

Credit used	\$2,500

ABC Jewelry then has a carry forward available for 1999 of \$1,500 and may use one hundred percent (100%) of that credit because it was carried forward from a year prior to January 1, 1998.

Example 2:

Sam and Joanne Taxpayer have a Rhode Island personal income tax of \$1,000 for 1998 and an investment credit carryforward from 1997 of \$700. Because the credit has been carried forward from a year before January 1, 1998, the taxpayers can reduce their tax by all of the \$700 leaving a balance due of \$300 as follows:

Tax	\$1,000
Investment Credit	700

Balance Due	----- \$ 300
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Example 3:

Gina's Pearl Company added qualifying assets during the calendar year 1998 which generated an investment credit of \$13,000 at the four percent (4%) rate and for 1998 the corporation (a "C" corporation) has a tax of \$11,000. Because the investment credit is at the four percent (4%) rate on or after January 1, 1998 the company will use \$10,750 of the credit to reduce its tax to the minimum filing fee calculated as follows:

Tax	\$11,000
Minimum Fee	250

Credit Used	\$10,750

The company will have investment credit carried forward to 1999 of \$2,250 and, depending upon its 1999 tax, the company can use one hundred percent (100%) of the credit in 1999 because, although it came from 1998, it was calculated at the four percent (4%) rate.

Example 4:

Steven and Jennifer Smith are shareholders in a subchapter "S" corporation which claimed investment credit for the calendar year 1998 using the four percent (4%) rate and Steven and Jennifer received \$500 of investment credit. Since the investment credit passed through to them was calculated at the four percent (4%) rate they can use their \$500 investment credit to reduce their 1998 personal income tax to zero (0) but not below.

IV. Property and Casualty Insurance Company

Effective June 30, 1999 and to the extent otherwise allowable, the credit shall also apply to property having a situs in Rhode Island and used by a property and casualty insurance company, however acquired. The term "however acquired" shall include acquisition by merger so long as the property had a situs in this state at the time of merger.

V. Recapture of Investment Tax Credit by a Qualified Taxpayer

The rules for recapture on qualified taxpayer acquisitions are the same as those cited in the law as it pertains to manufacturing companies based upon acquisitions prior to the enactment of this legislation and also set out in Part I of this regulation. In addition to those requirements, comparable rules shall be used in the case of property acquired by lease to determine the amount of credit, if any, that will be recaptured if the lease terminates prematurely or if the property covered by the lease otherwise fails to be in qualified use.

Recapture does not occur when the taxpayer subsequently fails to meet the classification as a "qualified taxpayer".

R. GARY CLARK
TAX ADMINISTRATOR

EFFECTIVE: January 1, 2001

THIS REGULATION AMENDS AND SUPERCEDES REGULATION CR00-04
PROMULGATED JANUARY 1, 2000.