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## INDIAN EMPLOYMENT CREDIT: Amend IRC § 45A to Make the Indian Employment Credit an Elective Credit for Employers Who Hire Native Americans

### TAXPAYER RIGHTS IMPACTED<sup>1</sup>

- *The Right to Pay No More Than the Correct Amount of Tax*
- *The Right to a Fair and Just Tax System*

### PROBLEM

Occasionally, the original intent of Congress in enacting legislation may be frustrated when the law interacts with other, existing provisions. Such is the case for the Indian Employment Credit (IEC), codified in Internal Revenue Code (IRC) § 45A. In 1993, Congress introduced IRC § 45A,<sup>2</sup> a provision that provides a monetary incentive in the form of a tax credit to employers who hire Native Americans who meet all the requirements of the provision.<sup>3</sup> IRC § 45A works by providing a *mandatory* tax credit based on the wages and employee health insurance costs paid by the employer to qualified employees in the taxable year.<sup>4</sup>

The Indian Employment Credit was created to encourage employers to hire more Native American workers in economically distressed communities, since many Native American reservations throughout the United States suffered “from staggering unemployment, nagging poverty, and huge infrastructure deficiencies.”<sup>5</sup> The credit is available only if the Native American employee of the employer claiming the credit lives and works on or near a recognized Indian reservation.<sup>6</sup> Furthermore, only the first \$20,000 of wages of the employee are eligible for this credit and wages paid by the employer to any employee who makes more than \$30,000 per year (adjusted for inflation) are not eligible for this credit.<sup>7</sup>

IRC § 45A is affected by two other provisions within the IRC. First, § 280C prohibits a deduction for the portion of wages and salaries paid in the taxable year which is equal to the sum of credits *determined* under § 45A.<sup>8</sup> This provision effectively prevents a taxpayer from benefitting both from the Indian

- 1 See Taxpayer Bill of Rights (TBOR), [www.TaxpayerAdvocate.irs.gov/taxpayer-rights](http://www.TaxpayerAdvocate.irs.gov/taxpayer-rights). The rights contained in the TBOR are also codified in the Internal Revenue Code (IRC). See IRC § 7803(a)(3).
- 2 IRC § 45A, Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66 (1993) (as amended by the Bipartisan Budget Act of 2018, Pub. L. No. 115-123, § 40301(a), 132 Stat. 64, 145) (2018)). IRC § 45A does not apply to taxable years beginning after December 31, 2017. See IRC § 45A(f). We are making this recommendation because it is likely that the Indian Employment Credit (IEC) may be extended again by Congress. The Indian Employment Credit has been repeatedly extended by Congress continuously since it was introduced in 1993. The Indian Employment Credit is claimed on IRS Form 8445, *Indian Employment Credit* (2017), <https://www.irs.gov/pub/irs-pdf/f8845.pdf>.
- 3 See IRC § 45A. This credit is often referred to as the “Indian Employment Credit.”
- 4 See IRC § 45A. This provision covers *any* employer, engaged in a trade or business, who pays wages to or health insurance costs for qualified Native American employees. The plain language of the statute indicates that the credit is not elective but rather mandatory. As discussed below, the Tax Court has interpreted the statute in the same way. See *Uniband, Inc. v. Comm’r*, 140 T.C. 230 (2013).
- 5 139 CONG. REC. S7815, 199-200 (daily ed. June 24, 1993) (statement of Senator John McCain) (during floor debate on H.R. 2264, the Senate adopted the provision with the Amendment 537).
- 6 IRC § 45A(c)(1)(C).
- 7 IRC § 45A(c)(2)–(3).
- 8 IRC § 280C.

Employment Credit and another deduction on the same costs. Second, IRC § 38(c) sets a cap on business credits generally, which includes IRC § 45A.<sup>9</sup>

The mandatory nature of IRC § 280C can sometimes result in an employer's tax liability *increasing* because it could result in a *mandatory* reduction of the employer's IRC § 162 deduction by the amount allowed under IRC § 45A while the allowable amount of credit is limited under the IRC § 38(c) general business credit limitation.<sup>10</sup> As mentioned earlier, the mandatory nature of IRC § 45A also contributes to this problem. This outcome, resulting in a disadvantage for the employer that would have been better off not having hired Native American employees, frustrates the original purpose of the credit.

### EXAMPLE

Company X is a small sand, gravel, and stone company which produces materials to be used for construction. Company X has been located on an Indian reservation in Pierre, South Dakota since 1990. It hires Native American members of the Sioux Nation reservation, located near the Cheyenne River, to work as construction equipment operators and warehouse technicians.

In Tax Year (TY) 1993 (*i.e.*, the base year for the credit), Company X's qualified wages paid for its qualified Native American employees were \$10,000 per year for each employee. Company X had two qualified Native American employees in TY 1993 with qualified wages of \$20,000 (\$10,000 each). In TY 2016, Company X had qualified wages of \$60,000 and two qualified employees (\$30,000 each).<sup>11</sup> Company X had no qualified employee health insurance costs in either tax year. The IRC § 280C limitation is applied separately to the TY 2016 for which the credit is being computed and to the base year—TY 1993. Thus, Company X's wages of \$60,000 for TY 2016 is limited to \$40,000 (*i.e.*, due to the \$20,000 cap for each employee). The \$20,000 for TY 1993 is then subtracted from the TY 2016 amount (\$40,000), leaving \$20,000, and the correct credit is 20 percent of that, or \$4,000. However, Company X has reached the cap of all allowable IRC § 38(c) business credits, and the Indian Employment Credit cannot reduce Company X's tax liability any further.

As a result, the company has a low Indian Employment Credit which cannot be claimed; however, to Company X's disadvantage, the IRS reduced Company X's total deductible wages that it could have claimed under the IRC § 162 business expenses by the Indian Employment credit amount of \$4,000 determined under IRC § 45A. The net result of the IRS's adjustments (*i.e.*, the disallowance of the Indian employment credit and the reduction of total wage deductions) resulted in a greater amount of tax for Company X.

Upon finding out about this disadvantage in the reduction of its total deductible wages, Company X tried to file an amended tax return arguing that IRC § 45A is elective, so that it can elect not to take the credit and not allow the IRS determination to stand. The IRS rejected the correction, however, arguing that the credit is mandatory, citing to the Tax Court's plain language interpretation of IRC § 45A in *Uniband*.<sup>12</sup>

<sup>9</sup> IRC § 38(c)(1).

<sup>10</sup> IRC § 38(c)(1); IRC § 280C(a). IRC § 280C(a) disallows a deduction for an amount of the wages equal to the credit for employment credits, including for IRC § 45A. The Indian Employment Credit is also subject to the limitations and carryover rules in IRC §§ 38 and 39. See IRC §§ 38 and 39.

<sup>11</sup> These figures are adjusted for inflation under IRC § 415(d). Beginning in 2009, the original § 45A(c)(2) limit of \$30,000 to be considered a qualified employee was adjusted for inflation to be \$45,000. See IRS Notice 2008-102, 2008-2 C.B. 1106.

<sup>12</sup> *Uniband, Inc. v. Comm'r*, 140 T.C. 230, 271 (2013) (internal citations omitted).

## RECOMMENDATION

In the event that Congress extends IRC § 45A, as it has in the past, and to promote the taxpayers' *rights to pay no more than the correct amount of tax and to a fair and just tax system*, the National Taxpayer Advocate recommends Congress amend the statute to make the Indian Employment Credit elective instead of a mandatory credit for employers who hire eligible Native American employees.<sup>13</sup>

## PRESENT LAW

In 1993, Congress created the Indian Employment Credit, to provide an incentive in the form of a tax credit to employers who hire eligible Native Americans who meet all the requirements of the provision.<sup>14</sup> For tax years beginning before 2018,<sup>15</sup> an employer may claim the Indian Employment Credit equal to 20 percent of the excess of the sum of qualified wages and the qualified employee health insurance costs paid or incurred during a tax year, over the amount paid or incurred by the employer during TY 1993 (the base year).<sup>16</sup> This credit must be claimed on the IRS Form 8445, *Indian Employment Credit*.<sup>17</sup> For the purposes of the Indian Employment Credit, the aggregate amount of the qualified wages and employee health insurance costs for any employee allowed for any given year is \$20,000 per tax year.<sup>18</sup> Furthermore, employees of the employer receiving wages or health insurance benefits above \$30,000 are not eligible to be included by the employer for this credit.<sup>19</sup> To qualify for this credit:

- 1) The employee or his or her spouse must be an enrolled member of an Indian tribe;<sup>20</sup>
- 2) The services performed by the employee for the employer must be performed within an Indian reservation;<sup>21</sup>
- 3) The employee's principal place of abode while performing the services must be on or near the Indian reservation where the services are performed;<sup>22</sup>
- 4) Over 50 percent of the wages paid or incurred by the employer to the employee during the tax year must be for services performed in the employer's trade or business,<sup>23</sup> and

13 On January 16, 2019, Senate Committee on Finance Chairman Charles Grassley stated that it is "too late" to renew extenders (such as IRC § 45A) for the 2018 filing season but that the Committee aims to renew extenders later in the year. See *Grassley: Time Up for Tax Extenders*, CONGRESSIONAL QUARTERLY NEWS (Jan. 16, 2019) (statement of Senate Committee on Finance Chairman Charles Grassley).

14 IRC § 45A, Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66 (1993) (as amended by the Bipartisan Budget Act of 2018, Pub. L. No. 115-123, § 40301(a), 132 Stat. 64, 145) (2018)). IRC § 45A does not apply to taxable years beginning after December 31, 2017. See IRC § 45A(f). We are making this recommendation because it is likely that the Indian Employment Credit may be extended again by Congress. The Indian Employment Credit has been repeatedly extended by Congress continuously since it was introduced in 1993. Most recently, in February 9, 2018, it was extended to apply to all tax years before December 31, 2017. See Pub. L. No. 115-123, § 40301(a), 132 Stat. 64, 145 (2018).

15 See IRC § 45A(f).

16 IRC § 45A(a)-(c).

17 IRS Form 8445, *Indian Employment Credit* (2017), <https://www.irs.gov/pub/irs-pdf/f8845.pdf>.

18 IRC § 45A(b)(3).

19 IRC § 45A(c)(2).

20 IRC § 45A(c)(1)(A).

21 IRC § 45A(c)(1)(B). For the purposes of this credit, an Indian reservation means a reservation as defined in § 3(d) of the Indian Financing Act of 1974 or § 4(10) of the Indian Child Welfare Act of 1978. See also *Instructions for Form 8845, Indian Employment Credit* (Feb. 27, 2018), <https://www.irs.gov/pub/irs-pdf/i8845.pdf>.

22 IRC § 45A(c)(1)(C). The statute restricts the employee's place of employment to on or near an Indian reservation in which the employment services are performed. The term "Indian reservation" is defined by IRC § 168(j)(6).

23 IRC § 45A(c)(4).

5) the employees cannot be a five percent or more owner of the company,<sup>24</sup> or a person employed in the gambling and gaming industry.<sup>25</sup>

Furthermore, under IRC § 38(c)(1), business credits, such as the Indian Employment Credit, may not exceed the excess (if any) of the taxpayer's net income tax over the greater of either the tentative minimum tax for the taxable year or 25 percent of so much of the taxpayer's net regular tax liability that exceeds \$25,000.<sup>26</sup> This further places a limitation in the form of a cap on the Indian Employment Credit and was aimed at preventing business taxpayers from using credits to reduce their tentative minimum tax.<sup>27</sup>

## REASONS FOR CHANGE

This potential disincentive that exists with using the Indian Employment Credit in certain situations can be avoided by making the credit an *elective* credit instead of a *mandatory* credit.<sup>28</sup> As explained above, the Indian Employment Credit was introduced to create an incentive to hire Native Americans on Indian reservations.<sup>29</sup> The credit was intended to “in some way attempt to address endemic and severe problems that exist on Indian country,” which exist because of “the failure of [the United States] to live up to treaty obligations.”<sup>30</sup>

A 2013 United States Tax Court case, *Uniband, Inc. v. Commissioner*, provides useful insight into how the credit is calculated and whether it is mandatory.<sup>31</sup> In *Uniband*, the taxpayer took its entire IRC §162 business deduction<sup>32</sup> instead of reducing the deduction and claiming the Indian Employment Credit, which the taxpayer was entitled to take.<sup>33</sup> The taxpayer in *Uniband* did this because the amount of the credit the company was eligible for was limited under the general business credit in IRC §38(c)(1).<sup>34</sup> IRC § 45A only provides an amount *determined* that becomes a component of what is *allowed* as a credit by IRC § 38(a).<sup>35</sup> The IRS adjusted the taxpayer's return by applying the limited credit and reducing

24 IRC § 45A(c)(5)(B).

25 IRC § 45A(c)(5)(C).

26 IRC § 38(c)(1). The statute defines “net income tax” as the sum of the regular tax liability and the tax imposed by IRC § 55 reduced by the credits allowable under subparts A and B of this part (*i.e.*, §§ 21 - 30D). IRC § 38(c)(1). The statute defines “net regular tax liability” as the regular tax liability reduced by the sum of the credits allowable under subparts A and B of this part (*i.e.*, §§ 21 - 30D). IRC § 38(c)(1). The term “tentative minimum tax” means the amount determined under IRC § 55(b)(1) (defining the term “qualified wages”).

27 See H.R. REP. No. 103-213, at 720-723 (1993) (Conf. Rep.). See also *Uniband, Inc. v. Comm’r*, 140 T.C. 230, 271 (2013) (internal citations omitted). The Tax Cuts and Jobs Act of 2017 repealed the corporate alternative minimum tax. See Pub. L. No. 115-97, § 12001, 131 Stat. 2054, 2092 (2017).

28 The Indian Employment Credit has been repeatedly extended by Congress since it was introduced in 1993. Most recently, in February 9, 2018, it was extended to apply to all tax years before December 31, 2017. See Pub. L. No. 115-123, § 40301(a), 132 Stat. 64, 145 (2018) (amending the provision to make it applicable to taxable years beginning after Dec. 31, 2016, as provided by § 40301(b) of Pub. Law. No. 115-123, which appears as a note to this section) amended subsection (f) by substituting “December 31, 2017” for “December 31, 2016”).

29 139 CONG. REC. S7815, 199-200 (daily ed. June 24, 1993).

30 *Id.* (statement of Senator John McCain) (during floor debate on H.R. 2264, the Senate adopted the provision with the Amendment 537).

31 *Uniband, Inc. v. Comm’r*, 140 T.C. 230 (2013).

32 IRC § 162(a) allows a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. IRC § 262, however, provides that no deduction is allowed for personal, living, or family expenses. IRC § 162(a); IRC § 262.

33 *Uniband, Inc. v. Comm’r*, 140 T.C. 230, 241 (2013).

34 *Id.* at 270.

35 *Id.* at 271.

the taxpayer's IRC §162 deduction by the full amount determined (but not allowed) under IRC § 45A.<sup>36</sup> This resulted in a net disadvantage to the taxpayer.<sup>37</sup>

The taxpayer in *Uniband* presented two arguments against the IRS's interpretation.<sup>38</sup> First, the taxpayer argued that the Indian Employment Credit is not mandatory, and therefore if a taxpayer chooses not to claim it then the taxpayer's IRC §162 deduction should similarly not be reduced.<sup>39</sup> Second, the taxpayer argued that IRC § 280C should be read as only limiting the deduction to the extent that the Indian Employment Credit is limited under IRC § 38(c)(1) to avoid frustrating the purpose of the Indian Employment Credit, which is to encourage businesses to hire more Native Americans.<sup>40</sup>

The Tax Court disagreed with both of the taxpayer's assertions in *Uniband*.<sup>41</sup> The court interpreted IRC § 280C as not contemplating the amount of credit that is "allowed," but rather requiring a deduction of the amount of credit that is "determined."<sup>42</sup> Therefore, the Tax Court reasoned that IRC § 280C is independent of whether the general business credit, and by extension the Indian Employment Credit, is fully allowed under IRC § 38(a) or limited by IRC § 38(c)(1).<sup>43</sup> The Tax Court declined to accept the taxpayer's policy argument, which it determined departed from the "plain language" reading of the statute as currently written.<sup>44</sup> Additionally, the Court pointed out that Congress can fix this issue by making it an elective credit.<sup>45</sup> The Tax Court's plain meaning interpretation of IRC § 45A and its reference to the legislative history of the research credit provision in IRC § 51(g), a different tax credit, with the same drawbacks as IRC § 45A, indicates that the Tax Court believes that the sole remedy is legislative, not judicial.<sup>46</sup>

Figure 2.9.1 is a table that shows the total number of taxpayers who have claimed the Indian Employment Credit for the past three tax years. As shown, the greatest amount of Indian Employment Credit claimed in the past three tax years was through IRS Form 1040, by individual taxpayers. In TY 2017, a total of 6,544 individual taxpayers claimed it on Form 1040, compared to 170 estates and trusts, and 455 corporations. As shown, in TY 2016, a total of 8,399 individual taxpayers claimed it on Form 1040, compared to 225 estates and trusts, and 948 corporations. Furthermore, in TY 2015, a total of 8,269 individual taxpayers claimed it on Form 1040, compared to 264 estates and trusts, and 978 corporations.

36 *Uniband, Inc. v. Comm'r*, 140 T.C. 230, 241 (2013).

37 *Id.*

38 *Id.* at 270.

39 *Id.*

40 *Id.* at 270-72.

41 *Id.*

42 *Id.*

43 *Id.* at 271.

44 *Id.* at 272.

45 *Id.*

46 *Id.*

**FIGURE 2.9.1, Indian Employment Credit Statistics for TY 2015–2017**<sup>47</sup>

Type of IRS Form Used by Taxpayers	Form 1040 (Individual Taxpayers)			Form 1041 (Estates and Trusts)			Corporations		
	TY2015	TY2016	TY2017	TY2015	TY2016	TY2017	TY2015	TY2016	TY2017
Total No. of Taxpayers Claiming I.E.C.	8,269	8,399	6,544	264	225	170	978	948	455
Total I.E.C. Claimed in U.S. Dollars	\$657,714,356	\$1,952,242,529	\$765,705,903	\$1,013,260	\$819,882	\$351,413	\$73,281,571	\$65,757,183	\$14,614,049

## EXPLANATION OF RECOMMENDATION

Congress can model IRC § 45A after the language in the work opportunity credit in IRC § 51(j), which states that “[a] taxpayer may elect to have this section not apply for any taxable year.”<sup>48</sup> The Tax Court in *Uniband* also pointed to other examples in the IRC where similar credits were elective.<sup>49</sup>

Considering the legislative purpose of IRC § 45A, described above, it would make sense to prevent a disincentive for employers by making the credit elective rather than mandatory. As the Tax Court observed, “Congress has shown that it is aware of the conundrum of the sort” and “it knows how to fix it when it wants to—*i.e.*, by allowing a credit determination to be optional in certain cases.”<sup>50</sup>

The Indian Employment Credit can be made elective or optional for employers by adding language such as in IRC § 51(j)(1) to the section 45A that would allow taxpayers to opt out in any taxable year.<sup>51</sup> That way, in situations in which employers are disadvantaged by taking the credit, they may avoid the disadvantage by electing not to claim the credit. Otherwise, the legislative intent to create an economic incentive to benefit Native American communities is frustrated because businesses would think twice about hiring Native American employees.

47 This data was obtained on Jan. 31, 2019, from the Business Returns Transaction File on the IRS Compliance Data Warehouse (CDW) (returns processed as of cycle 43) (data through Oct. 2018) and from the Individual Returns Transaction File on the IRS CDW (returns processed as of cycle 43) (data through Oct. 2018). The calculations for corporations in the figure combined data from IRS Forms 1120F, 1120L, 1120, 1120C, 1120PC, and 1120REIT for each tax year (TY) (TY 2015, TY 2016, and TY 2017).

48 IRC § 51(j)(1).

49 See *Uniband, Inc. v. Comm’r*, 140 T.C. 230, 271 n.33 (2013) (citing to elective language in IRC § 51(j)(1) (“A taxpayer may elect to have this section [work opportunity credit] not apply for any taxable year”); IRC § 40(f)(1) (“A taxpayer may elect to have this section [alcohol fuel credit] not apply for any taxable year”); IRC § 43(e)(1) (“A taxpayer may elect to have this section [enhanced oil recovery credit] not apply for any taxable year”); IRC § 45B(d)(1) (“This section [credit for portion of employer Social Security taxes paid with respect to employee cash tips] shall not apply to a taxpayer for any taxable year if such taxpayer elects to have this section not apply for such taxable year”); IRC § 45E(e)(3) (“This section [small employer pension plan startup cost credit] shall not apply to a taxpayer for any taxable year if such taxpayer elects to have this section not apply for such taxable year”); IRC § 45H(g) (“No credit [for production of low sulfur diesel fuel] shall be determined under subsection (a) for the taxable year if the taxpayer elects not to have subsection (a) apply to such taxable year”).

50 See *Uniband, Inc. v. Comm’r*, 140 T.C. 230, 270 (2013).

51 See IRC § 51(j)(1).