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The Kiplinger Tax Letter

Coordinated Issue Paper All Industries - State and Local Location Tax Incentives (Effective Date: May 23, 2008)

LMSB-04-0408-023
Effective Date: May 23, 2008

STATE AND LOCAL LOCATION TAX INCENTIVES
UIL: 118.01-02

ISSUES:

1. Does a state or local location tax incentive, whether in the form of an abatement, credit, deduction, rate reduction, or exemption (hereinafter referred to as a "location tax incentive"), give rise to gross income under I.R.C. § 61[1]?
    1. Does such a location tax incentive constitute a contribution to the capital of a corporation by a non-shareholder under I.R.C. § 118(a)?
    2. Does the amount of the location tax incentive reduce the corporation's basis in property under I.R.C. § 362(c)?
2. Is the amount of such a location tax incentive deductible as a tax paid or accrued during the taxable year under I.R.C. § 164?
3. Assuming for the sake of argument that the location tax incentive is an item of gross income, is it excludible as a non-shareholder contribution to capital under I.R.C. § 118 (a)?

CONCLUSIONS:

1. A state or local location or similar tax incentive is not income under I.R.C. § 61.
    1. Because it is not an item of gross income, a location tax incentive does not qualify for exclusion as a contribution to capital by a non-shareholder under I.R.C. § 118.
    2. For the same reason, a location tax incentive does not reduce a taxpayer's basis in property under I.R.C. § 362(c).
2. A location tax incentive, regardless of form, is not deductible as tax paid or accrued in the taxable year under I.R.C. § 164.
3. Even if a location tax incentive were treated as an item of gross income, it would generally not be excludible from income as a non-shareholder contribution to capital under I.R.C. § 118(a).

FACTS

Many state and local governments in the U.S. use a variety of competitive tax incentives over which they have some direct control to induce corporations to relocate to the community or to expand existing operations and investment. Local inducements may include one or more of the following: tax rate reductions, tax abatements, tax credits, exemptions from income or property tax, and tax credits for the creation of additional local jobs. Taxpayers generally treat such location tax incentives as reductions of local tax expense for federal income tax purposes.

Recently, however, some corporate taxpayers have argued that a location tax incentive should be viewed as an incentive payment to the taxpayer, coupled with a payment of the tax by the taxpayer. Under this approach, the corporation claims a tax deduction for the full, unabated, uncredited, or otherwise unreduced local tax liability under I.R.C. § 164. It also reports an amount equal to the tax reduction as section 61 income, which, however, the corporation asserts is excluded from income as a contribution to capital under I.R.C. § 118. The corporation then reduces the basis of property in the amount of the section 118

exclusion, citing I.R.C. § 362(c). This Coordinated Issue Paper sets forth the Service's analysis of the proper federal income tax treatment of these state and local location tax incentives.

For purposes of this discussion, the taxpayer is a corporation that files its federal income tax return on an accrual basis. The taxpayer is accorded location tax incentives, as described above, by various state and local taxing jurisdictions, in order to induce it to expand, relocate, or maintain facilities, or to increase jobs, within various taxing jurisdictions. The incentives may result from the application of state or local statutory provisions, and may be set forth in agreements between the taxpayer and the taxing jurisdiction. For financial purposes, the taxpayer generally accrues the net amount due to the taxing jurisdiction as an expense. For federal income tax purposes, however, the taxpayer claims a deduction under I.R.C. § 164 for the unreduced liability, reports an item of gross income excludable from income as a non-shareholder contribution to its capital under I.R.C. § 118(a), and reduces its basis in property in that amount, citing I.R.C. § 362(c).

LAW AND ANALYSIS

1. Location tax incentives, regardless of the form they take, are not income under I.R.C. § 61.

Gross income includes items of income from any source and in any form. I.R.C. § 61(a). "Gross income" includes all "undeniable accessions to wealth, clearly realized and over which the taxpayers have complete dominion." **Commissioner v. Glenshaw Glass**, 348 U.S. 426 (1955).

When a taxpayer is entitled to a tax abatement, credit, deduction, rate reduction, or exemption, the taxpayer generally is not regarded as realizing an accession to wealth that results in gross income. A state or local tax benefit of this type is applied against the taxpayer's current or future state tax liability, and is treated for federal income tax purposes as a reduction or potential reduction in the taxpayer's state or local tax liability. See, for example, Rev. Rul. 79-315, 1979-2 C.B. 27, Holding (3) (if all or a portion of a tax rebate is credited against tax due for a taxable year, the amount credited is treated as a reduction of the outstanding liability and the amount credited is neither included in income nor allowable as a deduction under section 164).

Snyder v. Commissioner, 894 F.2d 1337 (6th Cir. 1990) (unpublished opinion), illustrates this principle. In **Snyder**, originally decided by the Tax Court and reported at T.C. Memo. 1988-320, Northfield Park Associates ("NPA"), an Ohio partnership that operated a racing track, completed qualifying capital improvements which entitled NPA to a tax reduction. Generally, the state tax was based on a percentage of racing wages. However, the state provided for a tax reduction to holders of horse-racing permits who made certified capital improvements to their racing facilities, in the amount of 0.5% of the total amount wagered, continuing for six years or until the total reduction reached 70% of the cost of the certified improvements. The Service initially argued, and the Tax Court agreed, that the tax reduction was includible in income in the taxable year in which the state racing commission certified NPA's capital improvement costs.

Before **Snyder** reached the Sixth Circuit Court of Appeals, the Service acknowledged that its prior position regarding the tax reductions was erroneous, and agreed with the taxpayer that the proper treatment of the tax reduction was simply "to reduce the deductions available to [the partnership] for its pari-mutuel tax obligations, which reduced deductions accrue as those become due." The Sixth Circuit agreed with this analysis. The court noted that this case "does not involve any right on the part of NPA to receive an amount of money from the State of Ohio; it simply involves a right to start paying the state less in taxes than would have to be paid in the absence of the right." **Id**. The court held there was no "income" from the State of Ohio for the partnership to accrue. Similarly, in the case of location tax incentives, the taxpayer generally does not have a right to receive an amount of money that would result in income for federal tax purposes. While cancellation of an obligation that is due may result in gross income, **see**, **e.g.,** § 1.61-12(a), the taxes subject to the location tax incentives are never due and payable; rather, the location tax incentives operate to reduce the amount of tax that the taxpayer owes the local jurisdiction.

In certain circumstances, where a tax benefit is received in return for the provision of specific consideration in the form of services, property, or the use of property, it may be appropriate to view the taxpayer as having, in effect, satisfied the unreduced tax liability by a payment in kind. **See**, **e.g., Watervliet Paper v. Commissioner**, 16 B.T.A. 604 (1929); **Consolidated Edison Co. of N.Y. v. United States**, 10 F.3d 68 (2d Cir. 1993); Rev. Rul. 86-117, 1986-2 C.B. 157. Regardless of the proper federal tax treatment of such situations, a question not addressed in this paper, they are distinguishable from those involving location tax incentives, as defined here. State and local taxing jurisdictions grant location tax incentives to induce a taxpayer to expand, to maintain and/or to relocate facilities, and/or to promote job creation. The taxpayer does not provide any services or property to the taxing jurisdictions in exchange for the tax benefit; rather, location tax incentives are provided to induce activity which, while it primarily benefits the taxpayer, may also produce a general economic benefit to the state or local community. These tax incentives are not income but simply a reduction of the taxpayer's tax expense. **Snyder v. Commissioner, supra.**

a. Location tax incentives are not treated as gross income for purposes of I.R.C. § 61 and therefore do not constitute a non-shareholder contribution to capital under I.R.C. § 118(a).

I.R.C. § 118(a) provides that gross income does not include contributions to the capital of a corporation. The origin of the exclusion is the notion that contributions made to strengthen a corporation's capital structure or to enhance the contributor's ownership interest should not be considered income. As noted previously, location tax incentives are reductions or potential reductions in the taxpayer's state or local tax liability and do not constitute gross income under I.R.C. § 61. Thus, I.R.C. § 118(a), which is premised on the underlying existence of gross income, is not applicable.

Treas. Reg. § 1.118-1 explains that I.R.C. § 118 provides for an exclusion from gross income for **contributions of money or property** to a corporation. The exclusion applies to the value of land or other property contributed to a corporation by a governmental unit or by a civic group for the purpose of inducing the corporation to locate its business in a particular community. Treas. Reg. § 1.118-1. Tax benefits are not "money or property contributed to a corporation."

Case authority confirms that location tax incentives are not "contributions to capital." In **HMW Industries, Inc. v. Wheatley**, 504 F.2d 146 (3d Cir. 1974), for example, the Virgin Islands made "non-taxable subsidy" payments, equal to a percentage of taxes previously paid to the Virgin Islands, to certain businesses to induce them to locate and remain in the Virgin Islands. The court considered whether such payments made to a corporation were non-shareholder contributions to capital or simply tax rebates resulting in a net reduction of taxes. The court concluded that the subsidies were reductions in tax, not capital contributions.

b. Location tax incentives do not reduce basis under I.R.C. § 362(c).

If property other than money is received by a corporation as a contribution to capital and is not contributed by a shareholder as such, the basis of the property is zero. I.R.C. § 362(c)(1). If money is received by a corporation as a contribution to capital, and is not contributed by a shareholder as such, the basis of any property acquired with such money during the 12-month period beginning on the day the contribution is received shall be reduced by the amount of such contribution. I.R.C. § 362(c)(2). Property deemed acquired with the contributed money is that property, if any, the acquisition of which was the purpose motivating the contribution. Treas. Reg. § 1.362-2(a). As previously discussed, tax abatements, credits, deductions, rate reductions, or exemptions are not contributions to capital under section 118. **See, e.g., HMW Industries, supra.** Accordingly, I.R.C. § 362 does not apply. I.R.C. § 362(c)(1) has no relevance to such tax benefits; tax incentives are not used for the purchase of any property but simply reduce state or local tax liability, a periodic operating expense rather than a capital expenditure.

2. Location tax incentives are not deductible under I.R.C. § 164.

I.R.C. § 164(a) allows a deduction for certain taxes, including income taxes, real property

taxes, and personal property taxes imposed by local, state and foreign governments paid or accrued during the taxable year. **See also** Treas. Reg. § 1.164-1(a). In addition to the deduction for taxes set forth in I.R.C. §§ 164(a)(1) through (a)(5), I.R.C. § 164(a) permits the deduction of local, state and foreign taxes paid or accrued within the taxable year in carrying on a trade or business or an income-producing activity. [2]

In order to be entitled to a deduction under I.R.C. § 164, an accrual basis taxpayer must demonstrate that the tax liability to be deducted has accrued within the meaning of I.R.C. § 461. Under the "all events test" of I.R.C. § 461, an expense is deductible for the taxable year in which all the events have occurred that determine the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred. Treas. Reg. §§ 1.461-1(a)(2); 1.461-4(a)(1). With respect to state and local taxes, economic performance generally occurs as the tax is paid. Treas. Reg. § 1.461-4(g)(6).

In the case of location tax incentives, the taxpayer does not pay, and is not required to pay, any state or local taxes in excess of the amount remaining after all applicable abatements, credits, deductions, rate reductions, or exemptions. Thus, only the amount for which the taxpayer is liable after application of the location tax incentives is deductible.

Hurd Millwork v. Commissioner, 44 B.T.A. 786 (1941), **acq.**, 1941-2 C.B. 7, confirms this conclusion. In **Hurd Millwork**, the manufacturing facility of a corporation was destroyed by fire. Although the taxpayer remained solvent after the fire, it was not in a position to rebuild its plant without financial assistance. The facility was an important source of employment for the city in which it was located. Therefore, to assist and encourage the taxpayer to rebuild, the city passed a resolution pursuant to which the city would pay the company's real estate taxes for the year of the fire and three subsequent years. Nevertheless, the taxpayer accrued and deducted the full amount of the real estate taxes which would have been payable, absent the resolution, for the year of the fire. The court held that the taxes were not deductible, because the resolution was in place and the taxpayer's liability was extinguished prior to the end of the year. The court reasoned that the taxpayer's "accrued liability for 1936 real estate taxes would never be enforced against it, that is, that petitioner would never have to pay such taxes out of its own revenues." 44 B.T.A at 793. Likewise, the amount of tax eliminated by a location tax incentive is not deductible because the taxpayer never is liable for and never will pay it.

In some situations, the location tax incentive involves two payments: first, the taxpayer pays the tax; second, pursuant to the incentive provision, the state or local government rebates or refunds all or a percentage of the tax. This rebate may occur in the same tax year or in a subsequent tax year. In these situations, when there is a clear nexus between the tax payment and the rebate, the transaction is, in substance, a reduction in liability, even if, in form, it involves separate payments. **See, e.g., HMW Industries**, **supra**; Rev. Rul. 69-433, 1969-2 C.B. 153 (Virgin Islands "subsidy" payment is a reduction in tax). The situation is no different from one in which a taxpayer simply overpays its state or local tax and then receives a refund. In both situations, at the time the taxpayer pays its tax it has a fixed right to the refund or rebate. Accordingly, an accrual-basis taxpayer can only accrue and deduct the net amount. **See** Rev. Rul. 71-193, 1971-1 C.B. 144; **cf**. Rev. Rul. 82-208, 1982-2 C.B. 5 (cash-basis taxpayer). Even if, in a particular situation, the tax payment is fully deductible in the year it is made, the subsequent rebate or refund is not a separate payment that might be a nonshareholder contribution to capital; rather, it is a recovery of the previously-paid tax, and the tax benefit rule, partially codified in I.R.C. § 111, will apply to cause the rebate to be included in income to the extent of the prior deduction, resulting in a net effective deduction, over both years, equal to the reduced net tax liability. **Cf. Springfield Street Railway Co. v. United States**, 577 F.2d 700, 704 n.12 (Ct. Cl. 1978) (state payments a recovery of prior expenses, not I.R.C. § 118 contributions).

3. Even if a location tax incentive were treated as an item of gross income, it generally would not be excludible from income as a non-shareholder contribution to capital under I.R.C. § 118(a).

Even if, for the sake of argument, a location tax credit were treated as an item of gross income, a taxpayer must show that it satisfies each of the five factors required to qualify for non-shareholder contribution to capital treatment under **United States v. Chicago,**

Burlington & Quincy R.R. Co., 412 U.S. 401, 413 (1973). The Court in CB&Q analyzed whether an amount received is a capital contribution by a non-shareholder by utilizing the following factors:

a. The contribution must become a permanent part of the transferee's working capital structure;

b. The contribution must not be compensation for specific, quantifiable services provided by the transferee to the transferor;

c. The contribution must be bargained for;

d. The asset transferred must result in a benefit to the transferee commensurate with its value; and

e. The asset transferred ordinarily, if not always, will be used to produce additional income.

As an exclusionary provision, moreover, section 118 is strictly construed. **Commissioner v. Schleier**, 515 U.S. 323 (1995). Addressing each factor in turn:

a. The contribution must become a permanent part of the transferee's working capital structure.

Even if a location tax incentive were treated as an amount paid to the taxpayer, it is generally not conditioned on the taxpayer's actual use of the amount to acquire capital assets, and thus does not become a permanent part of working capital. In substance the incentive is simply a recovery of expenses of operations. See**, e.g., Springfield Street Railway, supra** (state grants based upon excise tax liabilities were reductions in tax liability and not contributions to capital, even though taxpayer acquired capital assets with the grants). The essence of a capital contribution is that it is used to enhance the taxpayer's capital structure, and is not available for use as the transferee sees fit. **Ibid.**

Payments cannot qualify as contributions to capital, where the payments "might be used for payment of dividends, of operating expenses, of capital charges, or for any other purpose within the corporate authority." **Texas & Pacific Railway Co. v. United States**, 286 U.S. 285, 290 (1932). **See also Baboquivari Cattle Co. v. Commissioner**, 135 F.2d 114 (9th Cir. 1943) (government conservation payments not excludable as contributions to capital).

b. The contribution must not be compensation for specific, quantifiable services provided by the transferee to transferor.

Even if a tax incentive were treated as an item of gross income, it would violate this second factor if it was contingent upon the provision of goods or services. Whether a payment is compensation for services is a highly factual inquiry. Even satisfying this factor alone would not establish that the incentives are contributions to capital under section 118, particularly when the incentives do not satisfy the first factor articulated by the Supreme Court in CB&Q. For example, the Court in CB&Q acknowledged that the railroad did not provide services in exchange for the payments at issue and nevertheless concluded that the payments were not contributions to capital. See 401 U.S. at 413-414.

c. The contribution must be bargained for.

Typically, location tax incentives do not result from any bargaining, but rather simply from the application of the state or local statutory tax provisions to the particular taxpayer involved. Thus, this factor would often be unmet even if a location tax incentive were treated as an item of gross income.

d. The asset transferred must result in a benefit to the transferee

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commensurate with its value.

In **CB&Q**, the Court inquired whether, after the transaction, the company was more valuable than if the transaction had never taken place. The Court concluded: "[W]hile some incremental benefit from lower accident rates, from reduced expenses of operating crossing facilities, and from possibly higher train speed might have resulted, these were incidental and insubstantial in relation to the value now sought to be depreciated, and they were presumably considered in computing the railroad's maximum 10% liability under the Act." 401 U.S. at 414. In essence, the Court reasoned that even when a tangible item is contributed to a taxpayer, resulting in a benefit equal to the fair market value of the asset, the taxpayer must demonstrate that it becomes a more valuable corporation as a result of the asset transfer. A location tax incentive, even if considered gross income, would not automatically constitute a benefit that enhances the value of the company by more than the amount of the deemed payment, without the requisite demonstration of enhanced value under **CB&Q**.

e. The asset transferred ordinarily, if not always, will be used to produce additional income.

In **CB&Q**, the Supreme Court premised its holding that the assets were not used for the production of additional income in large part on the fact that "the need of the railroad for capital funds was not considered." 412 U.S. at 414. Thus, payments cannot qualify as contributions to capital where the payments "might be used for payment of dividends, of operating expenses, of capital charges, or for any other purpose within the corporate authority." **Texas & Pacific, supra**, 286 U.S. at 290. **See also Springfield Street Railway; Baboquivari Cattle, supra**.

Accordingly, under the **CB&Q** factors, even if a location tax incentive were treated as an item of gross income, it would not be a contribution to capital within the meaning of I.R.C. § 118(a).

As the foregoing discussion indicates, the motivation of the transferor in making the payment is a crucial determinant of whether the payment constitutes a non-shareholder contribution to capital. This inquiry is factual in nature. If the payment is made in return for specific services, for example, the payments would not qualify as contributions to capital. Taxpayers may advance the argument that the transferor's public benefit motivation is controlling even if the contributions constitute compensation for services or do not become a permanent part of the transferee's working capital structure. It is important to recognize that in situations where the transferor has **dual** motivation (e.g., obtaining services as well as providing a public benefit), such a transfer is not a contribution to capital. As the Supreme Court stated in the **CB&Q** opinion, contributions to capital are those transfers that are "made with the purpose, not of receiving direct service or recompense, but **only** of obtaining advantage for the general community, as in **Brown Shoe** … ." 412 U.S. at 411 (emphasis added).

Rev. Rul. 93-16, 1993-1 C.B. 26, does not support the position that a tax incentive qualifies as a non-shareholder contribution to capital. In Rev. Rul. 93-16, the Federal Aviation Administration made a grant to a corporate owner of a public-use airport under the Airport Improvement Program. The taxpayer was required to use the grant for development, planning, and the purchase of navigation and other equipment. Thus, the grant became part of the taxpayer's working capital. The grant also had the possibility of generating additional income for the airport, through increased public use of facilities and services. A location tax incentive, in contrast, even if considered an item of gross income, generally does not become part of a taxpayer's working capital and does not generate additional income.

CONCLUSIONS

A state or local location tax incentive, whether in the form of an abatement, credit, deduction, rate reduction, or exemption, is not an item of gross income under I.R.C. § 61.[3] Rather, such an incentive is a reduction of state or local tax expense. This is true whether the taxpayer first pays the tax and then receives a rebate or refund, or pays only the net amount. The amount of such an incentive is not deductible as a tax paid or accrued under I.R.C. § 164. Location tax incentives are not non-shareholder contributions to capital under I.R.C. § 118, and do not reduce a taxpayer's basis in assets under I.R.C. § 362(c). Even if, for the sake of argument, a state or local location tax incentive were treated as an item of gross income, it generally would not be excludible under I.R.C. § 118.

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1. Location tax incentive" for purposes of this paper means any tax reduction, whether by means of abatement, credit, deduction, rate reduction, or exemption, which is accorded a taxpayer who agrees to locate in, remain in, or expand its operations in a particular area, to create additional jobs in a particular area, or otherwise to invest in or remain in a particular area.
   Generally, these credits are nonrefundable and nontransferable; that is, to the extent not absorbed by the taxpayer's tax liability, the credits
2. However, if such a tax is paid or incurred in connection with the acquisition or construction of a capital asset, it must be capitalized, rather than currently deducted. This capitalization rule does not apply to the taxes set forth in the first sentence of I.R.C. § 164(a).
3. This paper does not address, and is not intended to imply, the correct federal tax treatment of state or local refundable credits, transferable credits (including nominally nontransferable credits that are treated for federal tax purposes as transferable, under circumstances such as those described in IRS AM 2007-002, 2007 WL 465834 (January 26, 2007), or tax benefits provided in return for specific consideration such as services, property, or the use of property.