



Treatment of state tax incentives as contributions to capital

Refundable state tax credit is not a contribution to capital – relocation grant is

Background

Section 118 allows corporate taxpayers to exclude qualifying payments from income and instead reduce the basis of capitalized property. Property acquired in the year of payment is reduced first, followed by property placed in service in previous years. State authorities often induce corporations to relocate to a community or expand existing operations and investment by offering incentives in the form of tax credits for the creation of additional local jobs. Many corporations have applied section 118 to exclude state tax credits from income. As outlined previously in [LMSB-04-0408-023 \(May 23, 2008\)](#) and more recently in [FAA 20085201F \(Nov. 26, 2008\)](#), this is a position with which the IRS disagrees. However, the IRS in [PLR 200901018 \(Sept. 30, 2008\)](#) granted section 118 treatment to state relocation grants received by the taxpayer.

Analysis

Under the facts of FAA 20085201F, the taxpayer received the Michigan Economic Growth Authority (MEGA) credits from the State of Michigan for the creation of jobs in connection with the construction of its new manufacturing plant in Michigan. MEGA provides business activity and employment tax credits to businesses in order to “promote economic growth and to encourage private investment, job creation, and job upgrading” for Michigan residents. To be eligible for both the business activity and the employment tax credits, the taxpayer was required to create at least 75 qualified new jobs by a certain date and pay no less than 150 percent of the minimum wage, as set out in the agreement between the taxpayer and MEGA. The business activity credit is a credit of 100 percent of the portion of the taxpayer’s Michigan Single Business Tax (SBT) liability attributable to the building project for which the MEGA credit was granted. The employment credit is a credit of 100 percent of the State of Michigan’s personal income tax rate in effect for each tax year, multiplied by the total eligible salaries and wages of employees in qualified new jobs. The taxpayer is required to apply for the credits annually to prove that it meets all of the requirements. MEGA then issues the taxpayer an Annual Tax Certificate showing the approved credit amounts, which the taxpayer reports on its SBT returns. The business activity credit is nonrefundable, but the employment credit is refundable to the extent it exceeds the taxpayer’s SBT liability for a given year.

The IRS held that the refundable MEGA employment credit is: 1) gross income to the extent the taxpayer receives a refund of such credit, and 2) otherwise a reduction in state tax expense under section 164. Consistent with LMSB-04-0408-023, the IRS held that the nonrefundable MEGA business activity credit is always a reduction in state tax expense under section 164 (LMSB-04-0408-023 did not address refundable credits). In making its determination with respect to the nonrefundable business activity credit, the IRS relied on *Snyder v. Commissioner*, T.C. Memo 1988-320, noting that the taxpayer never has a right to receive any amount of money from the State of Michigan. As a result, the nonrefundable business activity credit is a reduction in the taxpayer’s tax liability, not an item of gross income.

Alternatively, with respect to the refundable employment credit, the IRS applied a bifurcated approach. The portion of the credit that is applied to reduce tax before the tax becomes due is treated as a reduction in



tax. To the extent the credit exceeds the tax liability and is made available to the taxpayer as a cash payment, it is treated as a payment from the State of Michigan and includible in income unless section 118 applies (the IRS noted that because such a payment is not a refund of prior taxes paid, it is not treated as a tax refund eligible for exclusion under section 111).

In further holding that section 118 does not apply to the refunded portion of the MEGA employment credit, the IRS determined that the payment fails the first factor of *U.S. v. Chicago, Burlington, & Quincy Railroad Co.*, 412 U.S. 401 (1973) (i.e., it does not become a permanent part of the taxpayer's working capital). According to the IRS, the payment fails the first factor because the credit: 1) first reduces the taxpayer's SBT liability (an operating expense), and 2) is measured with reference to the taxpayer's expenses for the SBT and employee salaries rather than conditioned on its use of such an amount to acquire capital assets. Thus, the IRS held that because the intent of the State of Michigan is to subsidize operating expenses (i.e., employee compensation), the payment of the MEGA employment credit cannot constitute a contribution to capital excludible from gross income under section 118. Because section 118 does not apply, section 362(c) also is not applicable.

It is important to note that the refundable state tax credits at issue in FAA 20085201F are distinguishable from the state grants that qualified for section 118 treatment in PLR 200901018 (Sept. 30, 2008). Specifically, under the facts of PLR 200901018, the taxpayer entered into an economic development agreement with a state, pursuant to which the taxpayer received grant disbursements in exchange for the expansion of its business by establishing a facility in a specified location. The grant disbursements were paid out of a state fund established to encourage economic development within the state. Based on these factors, the IRS determined all the requirements of *U.S. v. Chicago, Burlington, & Quincy Railroad Co.*, *supra*, were met, i.e., the grant payments: 1) became a permanent part of the taxpayer's working capital structure, 2) were not compensation, 3) were bargained for, 4) benefited the taxpayer in an amount commensurate with their value, and 5) ordinarily would be employed in or contribute to the production of additional income. Unlike the refundable state tax credits received by the taxpayer in FAA 20085201F, which were calculated based on the amount of salaries and wages paid by the taxpayer to new employees in qualified jobs, the grant payments received by the taxpayer in PLR 200901018 were received for the construction of a new facility in an agreed-upon location in the state.

Items to consider

The use of state tax credits is a common practice for many states attempting to attract employment opportunities for their residents. FAA 20085201F is the first guidance to address the tax treatment of refundable state tax credits, and its conclusions further highlight the fact-specific nature of section 118, the IRS's narrow interpretation of section 118, and the importance of written tax advice on such a contentious issue (see, e.g., [Industry Directive #3 on Section 118 Abuse](#) (includes discussion of state and local subsidies, grants, payments, etc. and sample [Generic Section 118 Information Document Request](#)) and [Tier I Issue: Section 118 Abuse Directive #4](#) (addressing nonrefundable state and local tax incentives)). It is also important to note that a change in method of accounting to properly apply section 118 is generally eligible for automatic consent under App. Sec. 14.14 of Rev. Proc. 2008-52. (See also, Rev. Rul. 2008-30). Thus, instead of filing either refund claims to try to obtain previously forgone section 118 benefits or



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amended returns to correct the misapplication of section 118, taxpayers are required to request IRS consent via the filing of Form 3115, Application for Change in Accounting Method.

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