5-30-2016

Federal Taxation of State Tax Credits

Alan Feld
Boston Univeristy School of Law

BU School of Law

FEDERAL TAXATION OF STATE TAX CREDITS

Boston University School of Law
Law & Economics Paper No. 16-24

151 Tax Notes 1243 (May 30, 2016)

Alan L. Feld

Boston University School of Law

Federal Taxation of State Tax Credits

By Alan L. Feld


Alan L. Feld

Alan L. Feld is a professor of law and the Maurice Poch Faculty Research Scholar at Boston University School of Law. He thanks his colleagues Ted Sims and David Walker for their helpful comments on earlier drafts.

In this article, Feld analyzes the federal income tax treatment of state incentive tax credits, discussing when the credits should be included in income and what their character should be.

Federal and state legislators have long used the taxing power to provide benefits as well as to impose burdens. Relief from the imposition of tax leaves money in a taxpayer's hands that otherwise would have gone to the government. Some benefit provisions smooth out perceived difficulties created by the tax structure itself, but many others serve as substitutes for direct expenditures. A dollar transmitted through the tax system enriches recipients just as much as a direct government grant. The extensive literature on tax expenditures canvasses and debates these effects but focuses chiefly on federal income taxation.[1] State legislators also have adopted this strategy and often provide tax incentives for favored activities. State tax incentives reward charitable giving,[2] economic development,[3] motion picture production,[4] environmental remediation,[5] renewable energy, and many other activities. Like their federal counterparts, state legislators may find conferring tax benefits to be more attractive than appropriating direct payments. Those tax law subsidies often become permanent because they avoid the annual review given to appropriations. They also permit legislators to describe the benefits as tax cuts rather than as increases in spending. Further, when a state constitution bars or limits gifts of state funds to private parties,[6] the tax credit alternative provides a simple mechanism for evading that limitation.[7]

The state and federal income tax systems operate mostly in parallel, each calculating its respective tax under its own rules. A state income tax may incorporate elements of the federal tax in its definitions and calculations, but state rules determine the measure of the levy. State income taxes paid or accrued give rise to federal tax deductions[8] — and any subsequent recovery of a deducted amount must be included in federal income[9] — but for the most part, the federal income tax ignores how state income taxes are calculated, including state tax expenditures.[10] However, when a state tax system provides a taxpayer with a net benefit, there is a corresponding effect in the federal tax system. Increasing a taxpayer's wealth mirrors the effect of a direct grant, and the federal income tax properly takes that enrichment into account.

This article explores the federal income tax treatment of state incentive tax credits, focusing on the Tax Court's recent opinion in *David J. Maines*[11] and an earlier opinion in *George H. Tempel*.[12] *Maines* examined the federal tax consequences of specific incentive state tax credits, applying general income definition rules to determine the proper federal tax treatment. *Tempel* addressed the character of a state credit as a capital asset. The opinions raise at least two kinds of questions: when the taxpayer should take the benefits of a state tax credit into account and what the tax character of the benefit should be.

---

[1] *See, e.g.*, Stanley S. Surrey and Paul R. McDaniel, ''Tax Expenditures: From Idea to Ideology,'' 99 *Harv. L. Rev.* 491 (1985).

[2] *See* Colo. Rev. Stat. section 39-22-522.

[3] N.Y. Gen. Mun. Law sections 955-969; and N.Y. Tax Law section 606(j).

[4] Mass. Gen. Laws Ann. ch. 62, section 6(f).

[5] CCA 200211042.

[6] N.Y. Const. Art. VII, section 8.

[7] *See Arizona Christian School Tuition Organization v. Winn*, 563 U.S. 125 (2011) (challenge to a tax credit as opposed to a government expenditure lacked standing under *Flast v. Cohen*, 392 U.S. 83 (1968)).

[8] Section 164, subject to the alternative minimum tax.

[9] Code section 111 and reg. sec. 1.111-1(a).

[10] ILM 201105010.

[11] *David J. Maines v. Commissioner*, 144 T.C. 123 (2015).

[12] *George H. Tempel v. Commissioner*, 136 T.C. 341 (2011).

Whether to Include a State Credit in Income

If a state simply pays an individual for engaging in a desirable activity, the payment ordinarily constitutes income for federal income tax purposes. A nonrefundable incentive tax credit resembles a direct cash payment from the state, applied against the state tax. The credit enriches the taxpayer by reducing state tax liability, but the taxpayer does not include it in income for federal tax purposes. One justification for this is that paying state tax would generally give rise to a federal deduction,[13] so that the income from receiving the credit and the deduction from paying the tax would simply net out.[14] The offset, however, does not apply in all cases. Netting will not occur if the taxpayer does not claim a deduction for state income tax purposes. Thus, a taxpayer who receives cash instead of a credit and uses it to pay the state income tax would not benefit from a federal deduction if the taxpayer claims the standard deduction, elects to deduct sales tax instead of income tax, or is subject to the alternative minimum tax. Nevertheless, both the IRS and the courts have excluded from income the receipt of nonrefundable credits that reduce state income tax liability.[15]

The exclusion reduces potential administrative complexity. State incentives can take the form of income tax deductions as well as credits. The rationale for including state tax credit subsidies in income should extend to benefits from deductions as well. Distinguishing deductions that constitute subsidies from those more closely related to the structure of an income tax would require close analysis and often result in disputed determinations. The analysis might vary from state to state. For most taxpayers, the state deduction, if included in income, would produce an offsetting federal tax deduction. The exclusion of state tax credits and deductions that reduce state tax liability from federal income eliminates the need to make administrative determinations that yield relatively little revenue.

Maines

When the state tax credit does more than reduce state income tax liability and leaves the taxpayer with cash, the result changes, and the federal tax system takes the cash into account. The taxpayers in *Maines* had benefited from three New York state tax credits. New York enacted its Empire Zones (EZs) program to stimulate investment and business development and to create jobs in impoverished areas in the state. Businesses can apply to be certified and to qualify for EZ tax credits. The credits vary depending on the amount of qualifying business activity. The EZ investment credit consists of 8 percent of the cost of tangible property in an EZ that meets specific other conditions. Corporate taxpayers apply the credits to their franchise tax liability. Passthrough entities get credits for use against the personal income tax liability of partners or members. New York calls the credits overpayments of income tax. Taxpayers may carry forward unused credits or in some circumstances may receive 50 percent of the unused credit as a refund. A second credit, the EZ wage credit, consists of a percentage of the business payroll of a qualified business in the EZ. The statute applies this credit in the same way as the EZ investment credit.

The taxpayers in *Maines* owned an S corporation and a limited liability company taxable as a partnership. Both business entities qualified to receive the EZ investment and wage credits. The taxpayers wiped out their state income tax liability with a combination of other tax credits and part of the EZ credits and paid no New York income tax. They received substantial amounts denominated as state income tax refunds. The taxpayers argued that the tax benefit rule applied to exclude the refunds from federal income: Because they had paid no state income tax and therefore took no deduction for it, a state income tax refund should not be included in income.[16] The Tax Court responded that the label New York affixed to the payment was not the controlling factor; the character of the payment was. It viewed the refunds as subsidies from New York to the taxpayers. The court held that while receipt of credits that reduce New York income tax is not a taxable event, the refund produced a taxable accession to wealth, includable in income.

The Tax Court employed a slightly different analysis to the third credit. The S corporation owned by David Maines and Tami Maines was entitled to the Qualified Empire Zone Enterprise (QEZE) real property tax credit. The amount of the credit equaled the real property taxes previously paid by the corporation during the relevant period. The credit passed through to the Maineses, who used part of the credit to offset New York income tax liability and received the remainder as a refund. The commissioner and the taxpayers again differed regarding the application of the tax benefit rule. The taxpayers argued that because they had claimed no prior federal income tax deduction for New York income taxes and because the credit refunds were denominated overpayments of income tax, the tax

[13]*See* ILM 200238041.
[14]*Cf.* section 108(e)(2).
[15]Rev. Rul. 79-315, 1979-2 C.B. 27; and *Tempel*, 136 T.C. 341.
[16]*See* section 111.

benefit rule required the refunds to be excluded from income. They also argued that the S corporation, not the individual taxpayers, had paid the real property taxes that constituted the measure of the credit. However, the Tax Court agreed with the commissioner. Despite the label, the credit actually constituted a refund of the real property taxes previously paid by the S corporation, the federal tax benefit of which had effectively passed through to the Maineses. The Tax Court accordingly applied the tax benefit rule to include the refunds in income.

Constructive Receipt

The Tax Court in *Maines* addressed the tax consequences to a taxpayer entitled to a refund of 50 percent of the credit who elects instead to carry forward the full amount of the credit.[17] It applied the doctrine of constructive receipt[18] to include in income the amount of the refund. This result seems wrong. The Tax Court cited the provision of the regulations that treats income as constructively received if made available for the taxpayer to draw upon if desired. The taxpayer's power to claim a refund meets this test. But the regulations limit the reach of constructive receipt if the taxpayer's control of receipt is subject to substantial limitations. In this case, to claim $1 of refund available under the New York credit, the taxpayer had to give up $2 of carryover to the following year. Without discussion, the Tax Court apparently treated this reduction of future credit as an insubstantial limitation. On the contrary, the loss of a 2-for-1 offset against future state tax liability would seem to meet the substantial limitation test and bar constructive receipt. The regulations treat as a substantial limitation a loss of three months' earnings on early redemption of a year-long certificate of deposit.[19] Loss of a substantial future tax credit should likewise constitute a substantial limitation.

Moreover, until the taxpayer acts, the effect of the credit conferred by the state remains in doubt. The taxpayer may either claim the 50 percent refund or apply the full amount of the credit carryforward against future state tax. Inclusion in income should occur when something definitively changes the credit from part of the state's tax calculation to an accession to wealth.

The Tax Court opinion leaves unresolved the federal tax treatment of the taxpayer in subsequent years. Suppose the taxpayer applies the carried-forward credit in the following year to reduce state income tax. Presumably, under the Tax Court's view, because the taxpayer recognized the amount of the refund as constructively received, the taxpayer should claim a deduction in the later year for the amount of income previously included. The taxpayer would have used up the credit without the kind of accession to wealth anticipated by the constructive receipt doctrine. But what statutory provision authorizes the deduction? The "loss" created by using the credit against state income tax does not fit well within the statutory categories in section 165(c); it does not constitute a loss incurred in a trade or business or in a transaction entered into for profit, nor is it a casualty loss. Constructive receipt would create an unduly harsh result if the taxpayer could claim no deduction.

Tempel

The taxpayers and the government in *Maines* both relied on an earlier tax court case, *Tempel*, in support of their respective positions. George and Georgetta Tempel donated a qualified conservation easement on land they owned in Colorado to a charity in 2004. Colorado provided a tax credit for that type of donation, up to a maximum of $260,000. They valued the easement at $836,500 and claimed the maximum income tax credit from the state of Colorado of $260,000. Colorado allowed taxpayers to obtain a limited refund if the state had a budget surplus for the year, but it had none in the year of the donation. Colorado also allowed taxpayers to carry forward any unused credits or to transfer credits to others who could then offset their own tax liability. The Tempels sold most of their unused credits at a discount from their face amount, receiving a total of $82,500 in exchange for $110,000 of their credit. They reported the sales as giving rise to short-term capital gains of $77,603, after they deducted from the sale proceeds as basis a portion of the expenses incurred in connection with the easement donation. The Tax Court treated the state tax credit as a capital asset and the proceeds of the sales as short-term capital gains but disallowed the claimed basis offset as outlays unrelated to the credit.

The *Maines* taxpayers argued that *Tempel* held that taxpayers do not include the receipt of refundable credits in income. The Tax Court noted, however, that the credits in *Tempel* were only potentially refundable and that no refund was available in the year the Tempels received and sold the credits. Their credits never led to cash refunds. The case accordingly did not constitute authority for excluding the refunds in *Maines* from income.

---

[17] While the Maineses did not carry the credits forward, the court said the case was one of 11 unconsolidated cases concerning federal tax treatment of the New York credits. *Maines*, 144 T.C. at 128 n.5.

[18] Reg. section 1.451-2(a).

[19] Reg. section 1.451-2(a)(2).

Capital Gain or Ordinary Income on Sale?

The capital asset holding in *Tempel* deserves further analysis. Although there may have been little practical difference to the Tempels between ordinary income and short-term capital gain once the court disposed of the basis claim, a taxpayer in a subsequent case could retain a credit for a year and a day and obtain long-term treatment on sale. Section 1221 defines a capital asset as property that does not fall into any of eight specific exceptions. The Tax Court said that the Colorado credit the taxpayers sold constituted property and that none of the statutory exceptions applied. It believed it was bound by *Arkansas Best*[20] to limit exclusions from capital asset treatment to the exceptions in the statute, concededly inapplicable, and to substitute-for-ordinary-income cases.

The Court in *Tempel* rejected a series of arguments that the sale proceeds substituted for ordinary income and that they should therefore be treated as ordinary income. The commissioner argued that the sale proceeds substituted for a tax refund that would have been includable as ordinary income, but the Tax Court countered that no state law opportunity to obtain a refund existed in 2004. The commissioner also argued that the credit's potential to reduce state tax liability produces the economic equivalent of ordinary income. By selling rather than using the credits, the taxpayer increases its section 164 deduction and reduces taxable income; in that sense, the sales proceeds substitute for income. The Tax Court rejected this argument as well, stating that a reduction in tax liability is not an accession to wealth and that a taxpayer who has an increased section 164 deduction has not received any income.

The Tax Court acknowledged that the case did not fit the purposes ascribed to capital gain treatment by the courts: to provide some relief from taxation in one year of appreciation accrued over a substantial period[21] or to alleviate the effects of inflation.[22] The Tempels' tax credit involved neither of those issues.

Nor did the court seek to reconcile the result with the lottery proceeds cases. Five circuit courts have considered the question whether the sale of periodic lottery payments for a lump sum gives rise to capital gain treatment.[23] All concluded that it does not — that the sale proceeds constituted a substitute for ordinary income — but their rationales have differed. The value of almost any asset consists of the discounted present value of the income expected from the asset, so that in some sense every sale substitutes for the future ordinary income. To distinguish ordinary income from capital gain on sale, the substitute for ordinary income argument must contain something more. The most recent lottery case, *Womack*, noted several important differences between lottery rights and the typical capital asset. First, the sale of a capital asset captures the increased value of the underlying asset. Second, the taxpayer makes an underlying investment in a capital asset. Third, a sale of lottery rights transfers a right to income already earned, not a right to earn income in the future. Fourth, a capital asset has the potential to earn income in the future based on the owner's actions, but lottery winners are entitled to their income by virtue of owning the property. Lottery rights lack these characteristics.

If we substitute the state tax credit for the lottery winnings in the analysis, the same arguments point to ordinary income treatment. The sale of a tax credit does not capture increased value. The taxpayer makes no underlying investment in the asset. The right transferred represents income already earned, not a right to earn income in the future. And recipients of tax credits are entitled to their income by virtue of owning the property, not future actions.

In two earlier cases, the Tax Court had developed a multifactor test for treating specific rights as capital assets. The test originated in *James E. Foy*,[24] a case involving contract rights to a franchiser, and received endorsement in *William T. Gladden*,[25] involving the sale of water rights. The six factors were: the origin of the rights; how they were acquired; whether they represented an equitable interest in a capital asset; whether the transfer of rights merely substituted the source from which the taxpayer would have received ordinary income; whether substantial investment risks were associated with the rights (and if so, whether they were included in the transfer); and whether the rights primarily represented compensation for personal services. The *Tempel* court declined to apply this test to the state tax credit, restricting the test to cases involving contract rights.

A subsequent chief counsel advice[26] agreed that a transferable state tax credit that does not fall within the statutory exclusions constitutes a capital asset.

---

[20]*Arkansas Best Corp. v. Commissioner*, 485 U.S. 212 (1988).

[21]*Commissioner v. Gillette Motor Transport Inc.*, 364 U.S. 130 (1960).

[22]*Burnet v. Harmel*, 287 U.S. 103 (1932).

[23]*Womack v. Commissioner*, 510 F.3d 1295 (11th Cir. 2007); *Prebola v. Commissioner*, 482 F.3d 610 (2d Cir. 2007); *Watkins v. Commissioner*, 447 F.3d 1269 (10th Cir. 2006); *Lattera v. Commissioner*, 437 F.3d 399 (3d Cir. 2006); and *United States v. Maginnis*, 356 F.3d 1179 (9th Cir. 2004).

[24]*Foy v. Commissioner*, 84 T.C. 50 (1985).

[25]*William T. Gladden v. Commissioner*, 112 T.C. 209 (1999), *rev'd on other grounds*, 262 F.3d 851 (9th Cir. 2001).

[26]CCA 201147024.

The chief counsel advice affirmed that, ordinarily, a taxpayer who qualifies for a state tax credit that can be applied only against current or future state tax liability does not have to include it in gross income. Citing *Tempel*, it said a transfer of the credit for value constitutes a sale. Basis is zero. Disagreeing on this point with the Tax Court, the chief counsel advice approved the application of the *Foy-Gladden* multiple-factor test to determine capital asset status. It said the same test that applies to contract rights should also apply to other kinds of property. It did not spell out how the application of the six factors leads to capital asset treatment for the state tax credit. It also did not cite an earlier and contrary chief counsel advice[27] conclusion, which said that sale of a Missouri remediation tax credit resulted in ordinary income.

But even treating the credit as a capital asset, the Tax Court and the chief counsel advice failed to take into account a more fundamental issue. As they noted, the code defines a capital asset as ''property'' held by the taxpayer. Not every valuable right constitutes property for this purpose.[28] A state tax deduction or a nonrefundable credit constitutes a beneficial part of the calculation of a taxpayer's liability to the state but does not itself constitute property. A refundable credit ripens into a property right when the taxpayer obtains a benefit independently of the state income tax calculation. At that point it crosses the line between the two tax systems and becomes an accession to the taxpayer's wealth. It is hard to see how a taxpayer can become the owner of property that constitutes a capital asset without first acquiring the property. That acquisition constitutes a realization event that requires inclusion in income.

A nonrefundable credit that a taxpayer sells to another taxpayer becomes an accession to the wealth of the seller no later than the time of sale. The credit then ceases to act as part of the taxpayer's calculation of state tax and becomes independently valuable. The sales price determines the value. The proper tax treatment for the Tempels should have begun with inclusion in ordinary income of the independent value they enjoyed from the credit, as measured by the sales proceeds. The sale of the credit then resulted in a second realization event but with no gain because the amount realized equaled the adjusted basis. As an analogy, consider an employee who expects to receive shares of the employer's stock as a bonus. When the shares are granted, the employee sells them. The employee has neither income nor property until the shares are received. When that occurs, the employee takes their value into account as ordinary income and takes a property right. The subsequent sale produces capital gain.

Treatment of a Purchaser of a State Tax Credit

For the purchaser of the state tax credit, the credit should qualify as a property right. Its adjusted basis equals the purchase price. When the purchaser applies the credit to satisfy state tax liability, a transfer of the property occurs, constituting a realization event. As with any transfer of property in satisfaction of a liability, the purchaser realizes gain or loss in the amount of the liability satisfied less the allocable portion of the adjusted basis. The use of appreciated property to satisfy an indebtedness results in gain recognition,[29] and the character of the property as a state tax credit should not alter that result.

Conclusion

State income tax credits ordinarily affect the federal income tax of the recipient by reducing the state tax liability and any corresponding federal deduction. They enter directly into the federal income tax calculation only when the taxpayer receives something more, in the form of a right to a refund from the state or the proceeds of a sale of the credit. Current authority treats gain on the sale of the credit as capital gain but fails to take account of the prior accession to wealth that occurs when the credit matures into a tradable property.

---

[27]CCA 200211042.

[28]*See, e.g.*, *Miller v. Commissioner*, 299 F.2d 706 (2d Cir. 1962).

[29]*See Kenan v. Commissioner*, 114 F.2d 217 (2d Cir. 1940).