

PUBLICATION

IRS Addresses State and Local Tax Incentives

June 16, 2008

On May 23, 2008, the Internal Revenue Service issued Coordinated Issue Paper LMSB-04-0408-023 (CIP) addressing its position as to the federal tax treatment of certain state and local tax incentives. Although a Coordinated Issue Paper does not have the force of a regulation or revenue ruling, it provides guidance as to the Service's current view on a particular subject.

The state and local tax incentives covered in this recent CIP are referred to as "location incentives." These types of incentives include abatements, credits, tax rate reductions and exemptions which are used by state and local governments to induce companies to relocate, expand or maintain facilities in a particular area.

Tax Strategy and Issues Addressed in the CIP. The IRS issued this CIP to counteract a strategy used by some corporate taxpayers of claiming a current federal income tax deduction for the full state or local tax incentive amount as if that amount had actually been paid by the taxpayer as a state and local tax. Under this strategy, the corporate taxpayer would recognize the incentive amount as gross income for federal purposes, but not as taxable income because such amount arguably would be treated as a contribution to the taxpayer's capital. In essence, the corporate taxpayer would get the federal tax deduction without any corresponding taxable income.

The IRS concluded in its CIP that such state and local tax incentives (1) do not result in federal gross income to the recipient taxpayer; (2) are not a contribution to the taxpayer's capital; (3) do not reduce the taxpayer's basis in its property; and (4) are not allowed as a deduction for taxes that are paid or accrued. Specifically, the Service determined as follows:

- **Not Includible in Gross Income**
The IRS, relying on Revenue Ruling 79-315, reasoned that location incentives are not included in income under Section 61 of the Internal Revenue Code (Code) because the tax incentives only reduce the amount of state and local taxes either currently owed or owed in the future, and the "taxpayer does not realiz[e] an accession of wealth" from the incentives.
- **Not a Contribution to Capital**
The IRS found that location incentives fail to satisfy the factors required to qualify as a contribution of capital under Section 118(a) of the Code because such incentives are not conditioned upon the taxpayer actually using the amount to acquire capital assets and are typically not the result of bargaining.
- **No Reduction to the Taxpayer's Basis**
The IRS also reasoned that because location incentives fail to qualify as a contribution of capital, the taxpayer's basis cannot be reduced under Section 362(c) of the Code. Section 362(c) requires a basis reduction for property which is deemed purchased by a contribution of capital under Section 118(a).
- **No Deduction for Taxes which are Paid or Accrued**
Section 164(a) of the Code allows a deduction for certain taxes imposed by local governments which are paid or accrued in the taxable year. The IRS denied the deduction for these state and local tax incentives because the taxpayer is not required to pay the tax relating to the incentive, thus the taxes were never paid or accrued. The IRS further noted that its position would also be applicable to state

and local tax incentives which require the taxpayer to pay the full tax amount and then receive a subsequent rebate.

In summary, and as noted earlier, the CIP only represents the IRS's current thinking on the issue and does not legally bind taxpayers to its position. Some commentators have suggested that taxpayers can reasonably implement this capital contribution strategy. Taxpayers considering doing so should proceed cautiously and with counsel from their tax advisors, however. Taxpayers should also be aware that the CIP demonstrates that the IRS will scrutinize this treatment of location incentives and will attempt to handle the issue in a uniform manner, which could slow audit resolutions. In addition, FIN 48 imposes a "more likely than not" standard of succeeding on the merits in order to recognize an income tax benefit. The CIP's issuance may make it more difficult to book the tax benefit of this strategy without first obtaining a formal legal opinion.

Relevant State Tax Incentives. For your convenience, listed below are some (but certainly not all) tax incentives offered by various mid-south states that may be considered as location incentives. However, these and any other incentives offered by a state or local government must be reviewed on a case by case basis to determine the applicability of the Service's CIP.

Alabama

Alabama Income Tax Capital Credit (Ala. Code §§40-18-190, *et seq.*)
Ad Valorem Tax Abatements (Ala. Code §§ 40-98-1, *et seq.*)
Construction-Related Transactions Tax Abatements (Ala. Code §§40-9B-1, *et seq.*)
Alabama Enterprise Zone Credit (Ala. Code §§41-23-20, *et seq.*)

Georgia

Investment Tax Credit (O.C.G.A. §48-7-40.8)
Jobs Credit (O.C.G.A. §48-7-40)
Worker Training Credit – Basic Skills (O.C.G.A. §48-7-40)
Headquarters Credit (O.C.G.A. §48-7-40.17)
Mega-Project Tax Credit (O.C.G.A. §48-7-40.24)
Qualified Research Credit (O.C.G.A. §48-7-40.12)

Louisiana

Enterprise Zone Program (La. R.S. §§51:1781-1791 *et seq.*)
Quality Jobs Program (La. R.S. §§51:2451-2462 *et seq.*)
Industrial Tax Exemption Program (La. R.S. §§47:4301-4306 *et seq.*)
New Markets Tax Credit (La. R.S. §47:6016)
Inventory Tax Credit (La. R.S. §47:6006)
Angel Investor Tax Credit (La. R.S. §47:6020.1)
Corporate Jobs Tax Credit (La. R.S. §47:287.749)

Mississippi

Jobs Tax Credit (Miss. Code Ann. §57-73-21)
Rural Economic Development Credit (Miss. Code Ann. §§57-10-401, *et seq.*)
Skills Training Tax Credit (Miss. Code Ann. §57-73-25)
Research and Development Skills Tax Credit (Miss. Code Ann. §57-73-21(6))
Fee-In-Lieu Incentive (Miss. Code Ann. §57-75-5)
Industrial Exemption (Miss. Code Ann. §§27-31-101 *et seq.*)
Inventory Exemption (Miss. Code Ann. §27-31-7)

Tennessee

Jobs Tax Credits (Tenn. Code Ann. §67-4-2109(c))

Industrial Machinery Tax Credit (Tenn. Code Ann. §67-4-2009(4))

Hospital Company Tax Credit (Tenn. Code Ann. §67-4-2009(6))

Finished Goods Exemption (Tenn. Code Ann. §67-4-2108(a)(6))

Headquarters Incentive Initiative (Tenn. Code Ann. §§67-6-224 and 4-2009(4)(H))

Industrial Machinery Exemption (Tenn. Code Ann. §67-6-206)

Qualified Data Center Incentives (Tenn. Code Ann. §67-6-206)

Emerging Industry Credit (Tenn. Code Ann. §67-6-232)