

**COLUMBIA TAX STUDY GROUP**

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**FEDERAL TAX CONSEQUENCES OF STATE  
ECONOMIC DEVELOPMENT INCENTIVES**

**Burnet R. Maybank III  
James P. Rourke  
Nexsen Pruet, LLC  
1230 Main Street, Suite 700  
Columbia, SC 29201  
(803) 771-8900  
[bmaybank@nexsenpruet.com](mailto:bmaybank@nexsenpruet.com)**

## A. General

As noted in the CLE, *The Taxability of Capital Subsidies and other Targeted Incentives Conferred by Governments Upon Private Businesses*, “the tax treatment of outright grants or property and cash transferred by governmental authorities to business owners is not, and has never been, clear.” The article concludes:

- Incentives that take the form of decreasing otherwise deductible costs, such as property taxes and rents, are generally excluded from gross income under current law.
- Operating subsidies, as well as cash transfers by a governmental entity to a business owner not earmarked for the acquisition of any particular capital asset, are generally taxable.
- Transfers of property in kind, as well as of cash earmarked to construct or purchase property to be owned by the transferee, are generally excluded from gross income if the transferor receives no *quid pro quo*<sup>1</sup> and the transferee is a *corporation* entitled to rely on section 118(a) of the code. (Emphasis added.)

On May 23, 2008, the Internal Revenue Service issued Coordinated Issue Paper LMSB-04-0404-023 (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 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.

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<sup>1</sup> An example of a *Quid Pro Quo* is where a city gave a grant to construct a baseball stadium and required the owner to provide 50 free parking spots for city employees.

As stated in IRS *Tier I Issue: IRS Section 118 Abuse Directive #4*, 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 generally (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.

## **B. Corporations**

The US Supreme Court held that Governmental Grants to corporations for economic development purposes were not income within the meaning of IRC §61 in *Edwards v. Cuba Railroad Co.*, 268 U.S. 628 (1925).

There were subsequently a number of Supreme Court and lower court cases on the related subject of whether government grants constituted a contribution of capital to the corporation. Congress finally stepped in and enacted IRC §118. Regulation 1.118-1 now provides:

Contributions to the capital of a corporation.

In the case of a corporation, section 118 provides an exclusion from gross income with respect to any contribution of money or property to the capital of the taxpayer. . . . Section 118

also applies to contributions to capital made by persons other than shareholders. For example, 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, or for the purpose of enabling the corporation to expand its operating facilities. However, the exclusion does not apply to any money or property transferred to the corporation in consideration for goods or services rendered, or to subsidies paid for the purpose of inducing the taxpayer to limit production.

In summary, governmental grants given to corporations are generally not considered taxable income. Even if they are included in gross income, they are excluded from taxation under section 118. (As stated above, the current battleground is where the taxpayer tries to include incentives in gross income.)

### **C. Partnerships and LLCs**

#### **1. No Section 118 Exclusion**

Alas, the rule is different for partnerships and LLCs. In the CLE referenced above as well as in the article *IRS Increases Scrutiny of Section 118 Abuse* (The Tax Executive) both articles state rather definitely that the IRS rejects any argument that the section 118 exclusion of governmental grants applies to partnerships.

The IRS has issued several Policy Documents since these articles went to press. In *IRS Industry Directive #3 of Section 118 Abuse* the IRS states:

Neither Code Section 118 nor any alleged common law “contribution to capital” doctrine permits the exclusion from income of amounts transferred to a non-corporate entity by a non-owner. The legislative history to Code Section 118 is clear that the provision codified the preexisting case law, all of which case law addressed the issue of whether amounts transferred to a corporation by a non-shareholder were excludable from income. Thus, neither the preexisting case law nor the Code supports the argument that amounts transferred to a non-corporate entity by a non-owner are excludable from income.

The articles discuss at length whether the IRS is wrong, but there is no-doubt as to the IRS's position.

## **2. Is it Gross Income?**

As stated above, virtually all of the modern case law and IRS policy documents ignore whether a grant constitutes gross income and instead focus on the issue of whether the grant meets the exclusion test of section 118. This is for two reasons: (1) in many, if not the great majority of the decisions, the taxpayer actually received a check from the government; (it's pretty hard to argue that a check is not income); and (2) the taxpayer argued the grant was includible in gross income for the reasons stated above.

Section 61(a) provides that, except as otherwise provided in Subtitle A (Income Taxes), gross income means all the income from whatever source derived.

Section 1-61-1(a) of the Income Tax Regulations provides that “[g]ross income means all income from whatever source derived unless excluded by law. Gross income includes income realized in any Form, whether in money, property, or services.”

The Supreme Court in *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955), held that gross income includes “instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion.”

## **3. Exclusion of Government Transfers**

If a particular grant was considered income there are two possible uncodified exclusions for partnerships and LLCs.

The IRS has long recognized an uncodified exclusion from gross income in cases where a governmental authority grants a valuable, transferable right to one or more taxpayers. In Revenue Rule 67-135, the IRS ruled that a taxpayer who won a Bureau of Land Management

drawing entitling him to lease oil and gas rights from the government at below fair rental value realized no income within the meaning of section 61. In Revenue Rule 92-16, the receipt of emission allowances under an EPA-sponsored program did not cause a utility to realize gross income. These rulings were recently cited in PLR 9851046 (Sept. 22, 1988) as supporting the nonrealization as income of revenues attributable to customer charges for transition costs under a state utility deregulation scheme. And no one has suggested that Congress' recent extension of U.S. copyright protection, by twenty years, to Disney's cartoon characters and others give rise to "gross income" within the meaning of the code.

#### **4. General Welfare Exclusion**

Finally, there is an uncodified "general welfare" exclusion from gross income that extends to many types of government grants to individuals, usually outside of the business context. The "general welfare" exclusion covers most subsidy payments to the poor, replacement housing payments, payment under the Disaster Relief Act and flood relocation payments. Social welfare payments such as these were recognized early as exempt, possibly by analogy to the exclusion for "gifts" and possibly on the practical ground that taxing poor people on the receipt of welfare payments would only necessitate a governmental gross-up.

In Revenue Rule 77-77, the IRS ruled that grants are made to Indian tribes by the federal government, for the purpose of expanding Indian-owned businesses, were excluded from tribal income under the general welfare doctrine. PLR 199924026 (March 19, 1999) addressed the taxability of economic development grants made by a tribal nation itself to individual tribal members. The program, which was federally sanctioned, was designed to overcome the scarcity of credit available to tribal members who wanted to start up their own small businesses. Cash grants were made to individuals and their businesses.

#### **D. “Refundable” Credits**

The IRS first addressed refundable credits in an Office of Chief Counsel Memorandum dated November 26, 2008, which addressed two Michigan Economic Growth Authority (MEGA) credits: the Business Activity Credit and the Employment Credit. The Business Activity Credit allows a 100% credit of Michigan’s Single Business Tax, capped at the tax due to the state. The Employment Credit, on the other hand, is refundable to the extent it exceeds a corporation’s Single Business Tax liability for a given year. The IRS characterized the Business Activity Credit as a mere reduction in tax liability, not subject to gross income exclusion, consistent with its above-mentioned CIP.

However, the IRS recognized the potential for gross income in Michigan’s refundable Employment Credit. Refundability, according to the IRS, is a narrow term limited to situations in which unused credits may be returned to the governmental entity in exchange for a cash payment above and beyond the actual tax due. Under this bifurcated approach, “refundability, by itself, does not cause the entire credit to be treated as a payment from the state. Instead, the portion of the credit that is applied to reduce tax before the tax becomes due is still generally treated as a reduction in tax, consistent with *Snyder*; only to the extent the credit exceeds the tax liability and is made available to the taxpayer as a cash payment is it treated as a payment from the state, includable in income unless some exclusion applies.” Therefore, excess credit paid back to a corporation above and beyond its tax liability will be treated as gross income

#### **E. South Carolina’s Job Development (§ 12-10-80) and Job Retaining (§ 12-10-95) Credits**

The IRS’s treatment of South Carolina’s Job Development and Retaining credits under the Enterprise Zone act is unlikely to have any federal income tax ramifications. Under both §§

12-10-80(B)(1) and 12-10-95(B), qualifying business may only claim an amount equal to or less than the withholding tax paid to the State. Under the language of § 12-10-80(B)(1), “[t]he maximum job development credit a qualifying business may claim for new employees is limited to the lesser of withholding tax paid to the State on a quarterly basis or the sum of” a formulaic percentage of gross wages. Under § 12-10-95(B), “[a] qualifying business is eligible to claim as a retraining credit against withholding the lower amount of . . . : (1) the retraining credit for the applicable withholding period [based on the statute]; or (2) withholding paid to the State for the applicable withholding period.” Refunds under both statutes, therefore, are capped at the withholding tax paid by the businesses. Although the businesses will receive a quarterly “refund” from the state after qualifying under the statute, these credits are not “refundable” according to the IRS definition, because the credits may only be refunded to the extent of the tax owed. Therefore, the value of the credits received will not be subject to gross income inclusion.

## **F. Other State Tax Incentives**

### **1. Property Taxes**

The major property tax incentives are fee-in-lieu, MCBP, and the manufacturers abatement. These incentives simply lower the property taxes which would otherwise be paid by the property tax owner. For the reasons stated above, they (the property tax savings) would almost certainly *not* be considered taxable income.

### **2. Sales Taxes**

South Carolina has a host of sales tax exemptions, particularly for manufacturers. These include exemptions for machinery and equipment, research and development, electricity, pollution control, material handling equipment and the like. Again, exemptions value of these almost certainly are not considered taxable income.

### 3. Income Taxes

South Carolina has the traditional 3 factor formula for many multi-state taxpayers, and the state is phasing in 100% sales factor. Some taxpayers use a gross receipts formula. In addition, the state has a host of income tax incentives, including Jobs Tax Credit and (in roughly half the counties) an Investment Tax Credit, among many others. None of these incentives are refundable. Again for the reasons stated above, these incentives are almost certainly not considered taxable income.

### 4. Governmental Grants

South Carolina, and a few counties have governmental grant programs. The state grant programs include the setaside funds, the closing fund as well as the RIF fund. Most (if not all) of these grant funds are in the form of a check made payable to the county for public (road, water & sewer) infrastructure improvements. In this scenario the grants would almost certainly not be considered taxable income.

On rare occasions, a grant program may benefit the economic development prospect directly, either through site prep, bricks & mortar, or M&E. This presents a tougher case if the grant is to a non-corporate entity (LLC) or there is a quid pro quo (e.g., the state or county requires something in return (free parking spaces.)).



## **Burnet R. Maybank, III** Member

Columbia, South Carolina  
Charleston, South Carolina

**E [bmaybank@nexsenpruet.com](mailto:bmaybank@nexsenpruet.com)**

**T 803.771.8900**

**F 803-727-1472**

### **PRACTICE AREAS**

- Alcohol: Beverages and Products
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### **BAR & COURT ADMISSIONS**

- South Carolina State and

Burnie Maybank is a member of Nexsen Pruet's economic development and banking & finance practice groups. He represents both public and private entities. Mr. Maybank returned to the firm's Columbia office in 2006 after serving as Director of the South Carolina Department of Revenue under Governor Mark Sanford from 2003 through 2005. He also served in that position under Governor David Beasley from 1995 to 1999.

Mr. Maybank's practice focuses on:

- Economic Development incentives
- State and Local Tax Controversy Work
- Exempt Organizations and Charitable Giving, including Conservation Easements
- Alcohol Beverage Control
- Regulatory Work before the Public Service Commission
- Public Finance

At the request of Senate President *Pro Tempore* Glenn McConnell, Maybank serves on the South Carolina Transportation Infrastructure Study Committee. The Senate created the group in August 2008 to examine the feasibility and benefits of public/private partnerships to improve the state's roads, highways and bridges.

Maybank received national press in 2005 regarding the Department of Revenue's investigation of potentially abusive conservation easement donations, as well as the Department's investigation under IRS Circular 230 of tax professionals who were involved in tax shelters.

### **CAREER HIGHLIGHTS**

- *Best Lawyers in America*

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Federal Courts

## EDUCATION

- University of North Carolina, B.A.
- University of South Carolina, J.D.
- Emory University, LL.M. in Taxation

## Burnet R. Maybank, III, *continued*

- Chair, S.C. Tax Realignment Commission (TRAC)
- S.C. Transportation Infrastructure Study Committee
- 2006 Palmetto Leadership Award from the S.C. Policy Council
- Director of the SC Department of Revenue (2003-2005)
- South Carolina's first Director of the Department of Revenue and Taxation (1995-1999)
- Member of the Coordinating Council for Economic Development and Chair of the Enterprise Zone Subcommittee (1995-99 and 2003-05)
- Legal Counsel to Former SC Governor Carroll Campbell
- Former Commissioner on the SC Public Service Commission
- Former Member of the Board of South Carolina's Department of Health and Environmental Control
- Received Order of the Palmetto from both Governor Carroll Campbell and Governor David Beasley
- Former SC Deputy Securities Commissioner in SC Secretary of State's Office
- Former General Counsel in the SC Secretary of State's Office
- Received the Compleat Lawyer Award from USC School of Law (1998)
- Past Board Member, South Carolina Economic Developers Association (SCEDA)
- L.H. "Sonny" Siau Award of Excellence from the South Carolina Association of Auditors, Treasurers, and Tax Collectors
- Past President, S.C. Agency Directors Organization
- Mr. Maybank served on the Transition Team for Governor Mark Sanford. Mr. Maybank is co-author of a number of books and law review articles including *South Carolina Tax Incentives for Economic Development; Local, State, and Federal Tax Incentives for Conservation Easements*; and *State Tax Crimes*, all published for the Department of Revenue; as well as *South Carolina Limited Liability Companies & Limited Liability Partnerships* (1st & 3rd Editions); *The Law of Automobile Insurance* (1st-5th Editions); and *South Carolina Nonprofit Corporate Practice Manual* (2007), published by the South Carolina Bar.

## CIVIC AND PROFESSIONAL MEMBERSHIPS

- Board Member, Palmetto Conservation Foundation

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**Burnet R. Maybank, III,** *continued*

- Past Board Member, South Carolina Economic Developers Association (SCEDA)
- South Carolina Administrative and Regulatory Law Association (SCARLA)