ROBERTS & HOLLAND LLP

April 16, 2015

Inclusion of Refundable Tax Credits in Income

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States often provide tax credits to encourage individuals and businesses to purchase and develop property, pay wages, or engage in other forms of economic stimulus and socially beneficial activities. Some such credits can be used only to reduce or to eliminate actual state tax liabilities of the person who is engaged in the "creditable" activity, or, if the credits are earned by a pass-through entity, actual state tax liabilities of the entity's owners. Other credits, however—often referred to as "refundable credits"—may be used to claim a tax "refund" even if the available credits exceed the relevant persons' state tax liabilities, or the relevant persons have no state tax liabilities at all.

One aspect of refundable state tax credits that may be given little thought by the state legislatures that authorize them is the federal income tax treatment of such credits once obtained. Credits that are not refundable have been held not to result in income for federal tax purposes, although they may indirectly increase federal tax liabilities by reducing state taxes for which deductions would otherwise be allowable and/or by resulting in a refund of a tax payment for which a deduction was already claimed with respect to a prior period (thereby resulting in an income inclusion under tax benefit principles).[1]

In the case of "refundable" state tax credits in excess of actual tax liabilities, the IRS has indicated in unpublished guidance that such amounts are includible in income unless an exclusion applies, but without citation of any case law in direct support for that conclusion.[2] A recent decision of the Tax Court concludes that state tax credits that are not needed to reduce actual state tax liabilities to zero and that are nevertheless "refundable" create accessions to wealth required to be included in federal taxable income.[3]

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Background in 'Maines'

Maines addresses the federal tax consequences of payments with respect to three New York State tax credits allowed to David and Tami Maines (the "Maineses") for the years at issue (2005 to 2007): the Qualified Empire Zone Enterprise (QEZE) Real Property Tax Credit, the Empire Zone (EZ) Investment Credit, and the EZ Wage Tax Credit.[4]

Each of these tax credits was conditioned on the existence of a qualified business engaging in business activity in specified areas within the state. The QEZE Real Property Tax Credit was computed by reference to real property taxes paid. The EZ Investment Credit was computed by reference to a percentage of the cost of tangible property acquired by a qualified business and located in an EZ, and the EZ Wage Credit was computed by reference to the number of individuals employed by such a business within an EZ.

The Maineses owned two business entities that qualified for these credits, an S corporation and a limited liability company classified as a partnership for federal tax purposes. As such, each entity was a pass-through entity for income tax purposes.

Other, nonrefundable credits not at issue before the Tax Court were, as permitted by state tax law, claimed in a manner that eliminated half of the state income tax obligations of the Maineses for 2005 and their entire state income tax obligations for 2006 and 2007. The "refundable" credits referred to above were then used to eliminate the balance of the Maineses' income tax liabilities for 2005 and to obtain further payments characterized by the state law as refunds of tax overpayments, overpayments that had, however, not actually been made in the real world. Both the Maineses and the government moved for summary judgment on the issue of whether the refundable tax credits in excess of the state tax liabilities of the Maineses for the years at issue resulted in taxable income to them under federal law.[5]

Discussion

The Tax Court opinion first discusses the well-established tax benefit rule (partially codified in Internal Revenue Code (Code) section 111) under which the recovery or refund in one year of an expenditure (such as a state income tax payment) made in an earlier tax period is treated as income if the earlier expenditure resulted in a tax benefit. Conversely, if the initial expenditure did not result in a federal tax benefit—for example, where an individual made a state income tax payment for a year in which the individual did not itemize deductions and therefore obtained no tax benefit from the state tax payment—section 111 provides that no income inclusion is required by reason of a refund of all or part of that payment in a later year.

The Maineses asserted that they did not claim state income tax deductions for the years at issue, that the state tax credit payments they received were characterized under state tax law as overpayments of income tax, and, therefore, that under the tax benefit rule as developed by case law cited in the opinion, those overpayments were not included in their federal taxable income.

However, the court concluded that, regardless of the label assigned to the payments by state law, the refundable credits, to the extent they exceeded the credits applied to reduce state tax liabilities of the Maineses and their entities,[6] were not a refund of previously paid state taxes but rather payments in the nature of subsidies. The court therefore agreed with the government that the excess refundable credits constituted "accessions to wealth"[7] includible in federal taxable income under Code section 61 absent the application of some other exclusion.

The Maineses further argued that the refundable credits should be excluded from income as a return or recovery of capital, citing authority dealing with, for example, the refunding by states of property tax payments and rent payments. The court found that authority to be distinguishable, however, as concerning situations where there was no tax benefit from the initial payment that gave rise to the refund.

The opinion did not close the door completely on the possibility that some portion of the payments received by the Maineses might be attributable to capital expenditures for which no tax benefit had been obtained (and which might therefore lead to a different result in terms of the treatment of the credit attributable to that expenditure being excludible from income). However, neither party had presented any evidence as to whether or not the Maineses' credits were attributable to capital outlays from which no federal tax benefit had been derived.

The court further concluded that, to the extent the credits were attributable to property tax expenditures that had been previously deducted, the effective refund of those previously deducted taxes through the refundable credit payments was inconsistent with the earlier deduction and therefore required inclusion of those credits in income under the tax benefit rule.

Constructive Receipt?

The opinion in *Maines* includes a paragraph beginning with the following statement, the latter part of which may be the most controversial part of the decision: "It is only the potentially refundable excess credits that must be included in gross income; and under the doctrine of constructive receipt, this is the case whether or not the Maineses elect to receive the excess or carry it forward." After very brief discussion of the constructive receipt doctrine, under which income not actually in the possession of a taxpayer may be deemed constructively received if it is available to the taxpayer, the court asserted that "there were no limits on the Maineses' ability to receive these payments. We must therefore hold that the Maineses have constructively received income equal to what they could have received as a direct payment even if they in fact chose not to do so."

Under the constructive receipt doctrine, however, income "is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions."[8] As least some portion of the credits at issue were apparently refundable only on a discounted basis such that the refund that would be received would be only 50% of the amount of the credit surrendered. A taxpayer might well decide in those circumstances that it prefers to carry the credit forward in the expectation of being able to use it on a dollar for dollar basis to offset a future, actual state tax liability.

Further, state tax authorities generally have the right to audit state tax refund claims, a right often zealously exercised by the New York State Department of Taxation and Finance. Taking such rights into account, the IRS has itself ruled that an accrual method taxpayer should take into income a state or local income or franchise tax refund only at such time as it is received or approved by the relevant state tax authority, rather than at the time when the claim for refund may first be made.[9]

In light of the considerations referenced above, the assertion in the opinion that constructive receipt principles should be applied in this context seems surprising, and hopefully will be reconsidered by this court or some other court.

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[1] See, e.g., *Tempel v. Commissioner*, 136 T.C. 341 (2011), aff'd sub nom. *Esgar Corp. v. Commissioner*, 113 AFTR 2d 2014-1210 (10th Cir.); IRC §111.

[2] See, e.g., CCA 201423021 (2014).

[3] *Maines v. Commissioner*, 144 T.C. No. 8 (2015).

[4] See N.Y. Tax Law §§606(bb), 606(j), and 606(k).

[5] *Maines* is one of eleven related Tax Court cases filed by residents of New York arising from disputes concerning the federal tax treatment of these credits.

[6] It was apparently undisputed that refundable credits used to reduce state tax liabilities did not result in gross income for federal tax purposes, although such credits might reduce the taxpayer's deduction for state taxes and, thereby, indirectly increase the taxpayer's taxable income. See *Tempel v. Commissioner*, 136 T.C. 341 (2011), at 350.

[7] *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955).

[8] Reg. §1.451-2(a).

[9] Rev. Rul. 2003-3, 2003-1 C.B. 252.