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Tax on Tax Credits: U.S. Tax Court Addresses Federal Taxation of Refundable State Credits in *Maines*

As more and more states offer refundable tax credits to induce economic development, it is critical for businesses weighing incentive offers to take into consideration the federal income tax implications of an award. While a payment may be called a "credit" and claimed on a state tax return, that payment might nonetheless constitute taxable income for federal tax purposes. Imposition of federal income tax on incentive payments can materially reduce their value and should be considered when weighing the potential benefit of an award. A recent United States Tax Court decision, *Maines v. Commissioner*,[1] demonstrates this risk.

Maines involved taxpayers receiving refundable New York Empire Zone[2] credits. Three types of credits were at issue: the Qualified Empire Zone Enterprise Credit for Real Property Taxes ("RPT Credit"),[3] the Empire Zone Investment Tax Credit ("EZIT Credit"),[4] and the Empire Zone Wage Tax Credit ("EZW Credit").[5] The credits were generated by two pass-through entities doing business in New York and then were passed through to the individual taxpayers, who claimed the credits on their New York returns. New York processed the returns and then issued refunds when the credits exceeded the taxpayers' liabilities.[6]

Inclusion in income of tax credit refunds not offsetting prior payments. The Tax Court looked to the substance of the refund payments in making its determinations and focused on whether the tax credits actually offset or reduced the taxpayer's tax liability.[7] It first dealt with the EZIT Credit and EZW Credit (collectively, "EZ Credits"), determining that the tax credit refunds constituted taxable income for federal tax purposes when the credits were claimed.[8]

The EZIT Credit is available to certain certified taxpayers that acquire or construct eligible property in an Empire Zone. The EZW Credit is similarly available to certain certified taxpayers but is based on the taxpayer meeting specific requirements relating to jobs, employees, and employment terms in the Empire Zone.

The EZ Credits are generally taken against the taxpayer's New York income tax liabilities. For New York tax law purposes, a refund of the EZ Credits is considered to be simply a tax refund, not income.[9] Despite New York's characterization of the EZ Credits, in *Maines* the Commissioner of Internal Revenue asserted that they were nothing more than cash subsidies and, thus, should be treated as taxable income to the taxpayers.

The Tax Court summarily rejected the taxpayers' position that the Commissioner was bound by New York's characterization of the EZ Credits, quoting President Abraham Lincoln's quip that "if New York called a tail a leg, we'd have to conclude that a dog has five legs in New York as a matter of federal law. . . . Calling the tail a leg would not make it a leg."[10] Accordingly, New York's characterization of the EZ Credits as refunds of New York taxes paid was "not necessarily controlling for federal tax purposes."[11]

Instead, the Tax Court considered what it saw as the substance of the EZ Credits and determined that the credits were not actually a refund of previously paid state taxes but instead were a tax-

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able accession to wealth since they were "just transfers from New York to the taxpayer—subsidies essentially."[12] Accordingly, the Tax Court held that the EZ Credits, to the extent actually or potentially refundable, constituted income to the taxpayer:

"We therefore hold that this excess portion [of the EZ Credits] that remains after first reducing state-tax liability and that may be refunded is an accession to the Maineses' wealth, and must be included in their federal gross income under section 61 for the year in which they receive the payment or are entitled to receive the payment unless an exclusion applies."[13]

The timing aspect of this holding is notable and could be problematic for taxpayers: Under the doctrine of constructive receipt, merely having a vested right to receive the refund of the tax credit could be enough to constitute taxable income.[14] For example, an election to carry a credit forward and apply it to the next year's state taxes may result in income in the year the credit vested and a deduction in the year the credit was applied to the tax liability.

In reaching its holding, the Tax Court distinguished situations where a taxpayer receives a refund of a tax or similar payment that did not previously generate a tax benefit to the taxpayer. For example, if a taxpayer paid state income tax but did not itemize the deduction in one year, then there is no income upon a refund of the tax in a subsequent year.[15] Similarly, the doctrine of return of capital applies to state refunds of property tax or certain rental payments.[16] Unlike these situations, the EZ Credits were not a recovery of prior expenditures and therefore were includable in income. The Tax Court also rejected an argument that the EZ Credits were nontaxable welfare payments.[17]

Imposition of federal income tax on incentive payments can materially reduce their value and should be considered when weighing the potential benefit of an award.

Application of tax benefit rule to credit refund offsetting prior deduction. The Tax Court's analysis for the RPT Credit differed because, unlike the EZ Credits, the RPT Credit was generated by a prior tax expenditure: the payment of property taxes. The RPT Credit works by granting an income tax credit based on payment of property tax. For pass-through entities, the property tax is paid at the entity level but the income tax credit passes through and is claimed by the entity's owners.

In contrast to its determination with respect to the EZ Credits, the Tax Court agreed with the taxpayers that the RPT Credit did not, in and of itself, result in a taxable accession to wealth since the credit offset real property taxes that the pass-through entities had previously paid.[18] Even so, the RPT Credit was includable in the taxpayers' federal taxable income based on the tax benefit rule, which provides that, to the extent a taxpayer obtains a refund of payments for which it received a tax benefit, such refund should be taxable.[19]

This application of the tax benefit rule ensures that a taxpayer does not get a double benefit by claiming a deduction for a loss that it did not actually incur because it was later reimbursed. As explained by the Court: "[The tax benefit rule] tells us to look at the subsequent event . . . and ask: If that event had occurred within the same taxable year, would it 'have foreclosed the deduction?'"[20]

In *Maines*, the taxpayers had received a federal tax benefit when one of the pass-through entities deducted property taxes in calculating its net real estate income. The reduced net real estate income flowed through to the taxpayers, who thereby enjoyed the benefit of the deductions. Accordingly, under the tax benefit rule the taxpayers were required to include the refunded RPT Credit in their federal taxable income.[21]

Implications for recipients of refundable tax credits. The *Maines* decision serves as a reminder to taxpayers of the imperfect overlap between federal and state and local tax provisions. State and local tax credits and other incentives are limited in their effect to state and local tax consequences; these state provisions can have unwanted federal tax implications. One should not assume that the federal government will follow a state's characterization of an incentive payment in all instances. Taxpayers should examine both the form and the substance of state and local tax credits and other incentives and their federal income tax effects when assessing exactly how beneficial those incentives will be.

Dissimilar characterization of tax credits under federal and state tax systems also creates administrative headaches and traps for unwary taxpayers. If inclusion of a state tax credit in federal income is required, then a taxpayer should be able to subtract that inclusion when calculating its taxable income for state purposes. For example, if, under the facts of *Maines*, the taxpayer generated a credit on its return in year 1 and received the refund in year 2, then it would include the income on its federal return for year 2 but potentially subtract that income in calculating state income for year 2.

The doctrine of constructive receipt also creates a trap: taxpayers will need to determine at which point a refundable credit vests. The carryforward of a nonrefundable credit is certainly not taxable, but the carryforward of a refundable credit could be taxable under the reasoning of *Maines*. ■