ISSUES AND ANSWERS
...and questions

ON FEDERAL INCOME TAXATION OF INCENTIVES

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Federal income tax on incentives is...

NOT NEW

26 USCA §61. Gross income defined

(a) General definition

Except as otherwise provided in this subtitle,
gross income means all income from whatever source derived, including (but not limited to) the following items:

1. Compensation for services, including fees, commissions, fringe benefits, and similar items;
2. Gross income derived from business;
3. Gains derived from dealings in property;
4. Interest;
5. Rents;
6. Royalties;
7. Dividends;
8. Alimony and separate maintenance payments;
9. Annuities;
10. Income from life insurance and endowment contracts;
11. Pensions;
12. Income from discharge of indebtedness;
13. Distributive share of partnership gross income;
14. Income in respect of a decedent; and
15. Income from an interest in an estate or trust.
WHAT’S NEW IS THE “TAX CUTS AND JOBS ACT”

(hereafter, Tax Cuts and Jobs Act, or HR 1)

Old Section of Internal Revenue Code
§118. Contributions to the capital of a corporation
(a) General rule
In the case of a corporation, gross income does not include any contribution to the capital of the taxpayer.

New Section of Internal Revenue Code
§ 118. Contributions to the capital of a corporation
Effective: December 22, 2017
(a) General rule.--In the case of a corporation, gross income does not include any contribution to the capital of the taxpayer.
(b) Exceptions.--For purposes of subsection (a), the term “contribution to the capital of the taxpayer” does not include:
(1) any contribution in aid of construction or any other contribution as a customer or potential customer, and
(2) any contribution by any governmental entity or civic group (other than a contribution made by a shareholder as such).
(c) Regulations.--The Secretary shall issue such regulations or other guidance as may be necessary or appropriate to carry out this section, including regulations or other guidance for determining whether any contribution constitutes a contribution in aid of construction.
"In the case of a corporation, ..."

"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."

IRS Industry Directive #3 of Section 118 Abuse

Translation: There never was a safe harbor for LLCs.
WHAT ARE THEY TRYING TO DO?

DON’T THEY KNOW THAT ECONOMIC DEVELOPMENT IS IMPORTANT?

WHY ARE THEY TRYING TO HURT INCENTIVES FOR PROSPECTS?

WHAT THEY ARE TRYING TO DO...

MILITARY MAXIM

I. ONCE IS HAPPENSTANCE
II. TWICE IS COINCIDENCE
III. THREE TIMES IS ENEMY ACTION

“THIS PROVISION WOULD REMOVE A FEDERAL TAX SUBSIDY FOR STATE AND LOCAL GOVERNMENTS TO OFFER INCENTIVES AND CONCESSIONS TO BUSINESSES THAT LOCATE OPERATIONS WITHIN THEIR JURISDICTION (USUALLY IN LIEU OF LOCATING OPERATIONS IN A DIFFERENT STATE OR LOCALITY).”

House Committee on Ways and Means

“[T]he provision would increase revenues by $7.4 billion over 2018-2027.” Congressional Joint Committee on Taxation.
WHAT INCENTIVES ARE SUBJECT TO TAX?

EXAMPLES

FREE LAND
For example, a contribution of municipal land by a municipality that is not in exchange for stock (or for a partnership interest or other interest) of equivalent value is considered a contribution to capital that is includable in gross income.

PROPERTY TAX ABATEMENT
By contrast, a municipal tax abatement for locating a business in a particular municipality is not considered a contribution to capital.

Conference Committee Report
(2) EXCEPTION.—The amendments made by this section shall not apply to any contribution, made after the date of enactment of this Act by a governmental entity, which is made pursuant to a master development plan that has been approved prior to such date by a governmental entity. Sec. 13312(b)(2) of HR 1
WHAT IS A MASTER DEVELOPMENT PLAN?

- NOT DEFINED IN HR 1
- HAS TO BE SOMETHING APPROVED BY A GOVERNMENTAL ENTITY
- TIF/TAD? URBAN REDEVELOPMENT PLAN? CITY MASTER PLAN FOR ITS DOWNTOWN?
THE MASTER DEVELOPMENT PLAN MIGHT BE A PATH TO TAX-FREE INCENTIVES in some cases

If permitted by state law and the redevelopment plan, TIF/TAD funds can be used to pay private development costs. Note- If there is a Constitutional or statutory prohibition of “gifts and gratuities”, compliance will be needed.

“Flexibility in project activities—Partly because it is not subject to many federal or state requirements, tax increment financing can be used for a broad array of activities, such as land assembly, demolition, or environmental remediation and other in-kind subsidies. Tax increment financing can also be used to subsidize a developer directly through land donations, for example. Moreover, TIF subsidies can be layered upon non-TIF subsidies offered by the municipality or state government.”

An Elected Official’s Guide to Tax Increment Financing, N. Greifer, GFOA
If no Master Development Plan, then incentives paid/contributions made after 12/22/17... might be taxable even if pre-committed in an MOU or grant agreement.

Example: Performance based incentives such as community grants earned by creating and maintaining certain levels of jobs.
WE ARE ALL IN THE SAME BOAT AS LLCs NOW

SS Uncodified Exclusions from Gross Income
POTENTIAL SAFE HARBORS
Uncodified Exclusions From Gross Income
BEST BET:
LACK OF DOMINION AND CONTROL

“When a taxpayer can demonstrate that it is essentially acting as an agent for the government and the relevant public benefits from the expenditures it is allowed an exclusion from gross income. [T]he taxpayer’s lack of dominion and control over the unfettered funds will be determining factor for the whether the income becomes includable.” (emphasis added)

Grant proceeds not held in special account
- Grant payments not earmarked
- No restriction on use of funds (could even be used as working capital)

FROM THE REGULATIONS

Where Edge Fund monies are expended for the public acquisition and/or improvement of privately used land, buildings, machinery and equipment, or other private assets, the assets must be owned or controlled by the applicant and leased or subleased to the private user.

FROM THE STANDARD PERFORMANCE & ACCOUNTABILITY AGREEMENT

3. Performance Standards. In consideration for the Development Authority’s assistance, the Company shall meet the following Performance Standards:

   The Company shall create ______ new full-time permanent jobs located in [City/County] (the “Committed Jobs”). ... 
   The Company shall make or cause to be made a private capital investment in the Project of at least $___________ in the form of expenditures as noted in the Award (“Committed New Investment”);
FIGURING OUT HOW “DOMINION AND CONTROL” APPLIES TO LEASES

THE TOTALITY OF THE INTEREST IN PROPERTY HAS BEEN CALLED THE “BUNDLE OF STICKS”
A LEASE SEPARATES THE BUNDLE INTO TWO SEPARATE, AND DIFFERENT, INTERESTS IN THE PROPERTY.

THE "FEE" (LEGAL TITLE; LESSOR’S INTEREST)

THE LEASEHOLD (LESSEE’S INTEREST)
ASSUME AN INCENTIVES STRUCTURE IN WHICH THE PUBLIC SECTOR PROVIDES THE INCENTIVE BY INVESTING IN PROPERTY IT LEASES TO THE ECONOMIC DEVELOPMENT PROSPECT.

THE ECONOMIC DEVELOPMENT PROSPECT WILL HOLD A LEASEHOLD INTEREST; IF IT ACHIEVES PERFORMANCE GOALS, IT WILL EVENTUALLY TAKE TITLE.

MEANWHILE, THE LEASEHOLD INTEREST REPRESENTS LESS DOMINION AND CONTROL THAN THE ENTIRE BUNDLE OF STICKS.
DOMINION AND CONTROL BY THE LESSEE CAN BE FURTHER REDUCED
BY ADDITIONAL RESTRICTIONS ON THE LESSEE CONTAINED IN THE LEASE

(1) We conclude that Diversified took a nontaxable usufruct. It has been said that a usufruct exists where the lessee takes only "a circumscribed and limited use of the ***14 premises and facilities," (punctuation omitted) Camp v. Delta Air Lines, 232 Ga. 37, 40 (205 S.E.2d 194) (1974), where "the restrictions imposed ... are so pervasive as to be fundamentally inconsistent with the concept of an estate for years," Allright Parking of Georgia v. Joint City-County Bd. of Tax Assessors, 244 Ga. 378, 387 (3) (260 S.E.2d 315) (1979), or where the owner retains "dominion and control" over the property or the business operated thereon. See Buoy v. Chatham County Bd. of Tax Assessors, 142 Ga. App. 172, 173 (235 S.E.2d 556) (1977).

Here, the provisions of the lease show that the authority retained dominion and control over the property and that Diversified took only a circumscribed and limited use of the premises. See, e.g., Macon-Bibb County, 262 Ga. at 120-121 (other restrictions in thirty-year lease of airport maintenance facility sufficient to establish usufruct even though the property could be used for any lawful purpose not in conflict with normal operations of airport); Eastern Air Lines v. Joint City-County Bd. of Tax Assessors, 253 Ga. 18 (315 S.E.2d 890) (1984) (nature ***15 of restrictions in thirty-year lease indicated that parties intended to convey only usufruct); Fulton County Bd. of Assessors v. McKinsey & Co., 224 Ga. App. 593, 595 (2) (481 S.E.2d 580) (1997) (other restrictions in lease of greater than five years sufficient to rebut presumption of an estate for years even though use of space only restricted to office space); Richmond County, 173 Ga. App. 278, 325 S.E.2d 891 (restrictions in fifty-year lease sufficient to establish usufruct where, among other things, use restricted to warehouse use, warehouse built according to plans approved by the authority/lessor, and the lessee agreed to conform to all laws and regulations).

WHAT ABOUT PUBLIC INFRASTRUCTURE?

Ordinarily, the expectation is that the economic development prospect would have insufficient dominion and control to incur a tax from the provision of public infrastructure.

It’s possible that facts and circumstances could produce a different outcome.

Thought Experiment: mixed-use development on parking podium financed by special service district bonds.
Problem

Keeping in mind, that it is the economic development prospect which is receiving the “contribution”, and that it is federal income taxation of that incentive which is the issue, why is it a state, local government or local authority issue whether or not that tax is paid?
And...
A tax diminishes the value of the incentive to the economic development prospect.

Specific Instructions
File Form 1099-G, Certain Government Payments, if, as a unit of a federal, state, or local government, you made payments of unemployment compensation; state or local income tax refunds, credits, or offsets; reemployment trade adjustment assistance (RTAA) payments; taxable grants; or agricultural payments. You must also file this form if you received payments on a Commodity Credit Corporation (CCC) loan. The officer or employee of the government unit having control of the payments, received or made, (or the designated officer or employee) must file Form 1099-G.

Box 2. State or Local Income Tax Refunds, Credits, or Offsets
Enter refunds, credits, or offsets of state or local income tax of $10 or more you made to recipients. These include most state tax credits and incentive payments that are paid under an existing state tax law and administered by the state taxing agency. Film maker incentive credits, home improvement credits paid in low income areas, and solar panel installation credits are some types of state programs which are generally reportable in box 2 if paid by the state taxing agency.

Do not enter in box 2 payments that are not state income tax refunds, credits, or offsets. This may include payments made under state grant, incentive, subsidy, or other individual assistance programs. Taxable grants are reported in box 6; see the instructions below. If recipients deducted the tax paid to a state or local government on their federal income tax returns, any refunds, credits, or offsets may be taxable to them. You are not required to furnish a copy of Form 1099-G or a substitute statement to the recipient if you can determine that the recipient did not claim itemized deductions on the recipient's federal income tax return for the tax year giving rise to the refund, credit, or offset. However, you must file Form 1099-G with the IRS in all cases.
CONCLUSIONS

1. There are a number of open issues with the impact of the law regarding the taxability of incentives.
2. Regulations are expected which should answer most of these questions.
3. Expect increased IRS enforcement efforts, potentially regarding governmental agencies.
4. Economic developers might have an opportunity in some cases to help their prospects by structuring incentives so as to at least defer the taxable event.
SCOPE

This Presentation is not exhaustive, but rather is intended to provide an overview of some of the key aspects of HR 1. Many issues which could be important in a particular case have been condensed or omitted in the interest of readability. This Presentation is not tax advice. Specific professional advice should be obtained before attempting to apply any information herein to any particular case.
THIS PRESENTATION AND MY WHITE PAPERS ON ECONOMIC DEVELOPMENT AND OTHER TOPICS CAN BE DOWNLOADED AT

http://danmcrae.com/whitepapers