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OFFICE OF
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The Honorable Richard L. Hanna
U.S. House of Representatives
Washington, DC 20515

Dear Mr. Hanna:

I apologize for the delay in responding to your letter of September 28, 2012, about the federal tax treatment of state tax credits used to promote economic development. Specifically, you inquired about the New York State Qualified Empire Zone Enterprise (QEZE) Program, which includes the QEZE Credit for Real Property Taxes.

The law provides that "gross income" means "all income from whatever source derived" (section 61(a) of the Internal Revenue Code (the Code)). The Supreme Court has consistently held that, in enacting section 61, the Congress intended to exert the full measure of its taxing power. Thus, we presume any accession to wealth to be gross income unless an exclusion applies.

Generally, a state income tax credit is treated for federal income tax purposes as a reduction or potential reduction in the original recipient's state tax liability to the extent that the taxpayer can only apply the credit against a current or future tax liability. Consequently, an original recipient of a state income tax credit is not generally treated as having an accession to wealth that results in gross income under section 61. Additionally, when an original recipient of a state income tax credit applies the credit to reduce a state tax liability, the taxpayer has a lower deduction for state tax under section 164 of the Code.

Some states provide "refundable" income tax credits, such as some of the credits in the QEZE Program. The term "refundable" means that the state can pay the credit to a taxpayer in the same manner as a tax refund to the extent it exceeds the taxpayer's income tax liability. This amount is not an actual refund of estimated tax payments or withholding originally paid to the state. The fact that such a credit is "refundable" 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 the recipient's state tax liability is still treated as a reduction in tax; only the portion that the state actually refunds is treated as a payment from the state, includable in gross income under section 61 unless some exclusion applies.

Over the years, in informal advisories, we have consistently applied these principles in determining the federal tax treatment of various refundable state income tax credits. For example, our Office of Chief Counsel has applied these principles to a refundable Wisconsin Jobs Credit (1996 WL 33320928; 1996 FSA Lexis 437), a refundable Minnesota Military Service Credit (CCA 200708003), and a refundable Michigan Economic Growth Authority Employment Credit (NSAR 20085201F). For your convenience, I have enclosed copies of those memorandums.

As mentioned in your letter, we addressed the federal tax treatment of the refundable QEZE Credit for Real Property Taxes in CCA 200842002. In that memorandum, we concluded that a taxpayer should treat the cash payment attributable to the refundable credit as a recovery of property tax, not income tax. Such a recovery is fundamentally inconsistent with a previous section 164 deduction for property taxes. Accordingly, a payment attributable to the refundable credit would be income under the inclusionary part of the tax benefit rule, subject to exclusion under the provisions of section 111 to the extent the earlier year's property tax deduction did not reduce the amount of federal income tax imposed.

The conclusion of CCA 200842002 is consistent with the long-standing administration of refundable state income tax credits – that the portion of the tax credit that exceeds the state tax liability and that the state refunds to the taxpayer is subject to federal taxation as gross income under section 61 unless a specific exclusion applies. Contrary to the suggestion in your letter, we are not aware of any formal or informal advisory before 2008 that suggested we should treat refundable New York State credits differently for federal income tax purposes than similar refundable credits enacted by other states. We understand the importance of the QEZE tax credits and other state tax credits to economic development, but as we are sure you understand, we must apply the tax law consistently to all taxpayers.

I hope this information is helpful. If I can be of further assistance, please contact me at
or at .

Sincerely,

Christopher F. Kane
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Office of Associate Chief Counsel
(Income Tax and Accounting)

Enclosures (3)