APPEALS

COORDINATED ISSUE PROGRAM

SETTLEMENT GUIDELINES

INDUSTRY: All

ISSUE: State and Local Location Tax Incentives (I.R.C. § 118 SALT)

COORDINATOR: Sharon T. Derrick

TELEPHONE: (404) 338-7326

UIL NO: 61.00-00, 164.00-00 and 118.01-02

FACTUAL/LEGAL ISSUE: Legal and Factual

APPROVED:

/s/ Reinhard Schmuck — 3-2-11

Reinhard Schmuck — **DATE**
Director, Technical Guidance (Acting)

/s/ Kirsten B. Wielobob — 3-2-11

Kirsten B. Wielobob — **DATE**
Director, Technical Services

EFFECTIVE DATE: March 2, 2011

APPEALS SETTLEMENT GUIDELINES
ALL INDUSTRIES
State and Local Location Tax Incentives I.R.C. § 118
UIL 61.00-00; 164.00-00; and 118.01-02

STATEMENT OF ISSUES:

Issue 1: Whether the receipt of state or local location tax ("SALT") incentives by a corporate taxpayer, exclusive of refundable or transferable credits, (1) gives rise to gross income under I.R.C. § 61, (2) constitutes a contribution to the capital of a corporation by a non-shareholder under I.R.C. § 118(a), and/or (3) reduces the corporation's basis in property under I.R.C. § 362(c)?

Issue 2: Whether SALT incentives are deductible as a tax under I.R.C. § 164 if paid or accrued by a taxpayer during the taxable year?

Issue 3: Whether SALT incentives received by a taxpayer, if determined to represent gross income, are excludible as a non-shareholder contribution to capital under I.R.C. § 118(a)?

Compliance Position:

Issue 1: A SALT or similar tax incentive: (1) is not income under I.R.C. § 61, (2) is not a contribution of capital under I.R.C. § 118(a), and (3) therefore does not reduce a corporation's basis under I.R.C. § 362(c). This is because these tax incentives, whether in the form of an abatement, credit, deduction, rate reduction or exemption, simply reduce the tax imposed by state or local governments.

Issue 2: A SALT incentive, is not deductible as tax paid or accrued in the taxable year under I.R.C. § 164 because a taxpayer does not pay, and is not required to pay, any state or local taxes in excess of the amount remaining after all applicable abatements, credits, deductions, rate reductions, or exemptions.

Issue 3: A SALT incentive will not qualify for exclusion as a contribution to capital by a non-shareholder under I.R.C. § 118(a) even if it were an item of gross income because SALT incentives do not meet the five factors required to qualify for non-shareholder contribution to capital treatment as determined by the U.S. Supreme Court in United States v. Chicago, Burlington & Quincy R.R. Co. , 412 U.S. 401 (1973)[hereinafter CB&Q].

Taxpayer Position:

Issue 1: A SALT or similar tax incentive is income under I.R.C. § 61. Treas. Reg. § 1.61-14(a) specifically provides that another person's payment of the taxpayer's income taxes constitutes gross income to the taxpayer unless excluded by law. Relief from a liability is an accession to wealth within the meaning of I.R.C. § 61. As noted, the regulations state that relief from the payment of a tax liability is a realized accession to wealth that constitutes income within the meaning of I.R.C. § 61 —this is the case regardless of which party provides the relief from taxes. SALT incentives constitute a contribution to the capital of a corporation by a non-shareholder under I.R.C. § 118(a), and reduce the corporation's basis in property under I.R.C. § 362(c).

Issue 2: A SALT incentive is deductible as taxes paid or accrued in the taxable year under I.R.C. § 164. Payment of taxes includes the furnishing of cash and cash equivalents as well as the netting of offsetting accounts. Treas. Reg. § 1.461-4(g)(1)(ii)(A). Tax incentives represent consideration from the state or locality to induce the taxpayer to expand its operations and make significant capital investments within each state. This consideration takes the form of a tax incentive which can satisfy a portion of the taxpayer's tax liability, or alternatively, is in the form of a refund check, is irrelevant. The receipt of tax incentives is appropriately characterized as an inducement payment that is included in income. See Consolidated Edison Co. of New York, Inc. v. United States, 10 F.3d 68 (2nd Cir. 1993) (allowing taxpayer to deduct the entire tax amount, prepaid property tax amount as well as the discount amount, as property taxes paid).

Issue 3: If a SALT incentive is treated as an item of gross income, it would be excludible from income as a non-shareholder contribution to capital under I.R.C. § 118(a). In distinguishing SALT incentives from generic reductions in tax, SALT incentive payments are designed to obtain the investment commitment from the taxpayer to undertake certain activities. As such, these tax incentive payments represent the taxpayers' receipt of a capital contribution from the states and/or locality. Therefore since the tax incentive payments provided by the states are payments-in-kind in consideration for investment activity, the tax incentive payments represent a contribution to capital under I.R.C. § 118. Specifically, Treas. Reg. § 1.118-1 describes the type of circumstances envisioned for application of I.R.C. § 118 to non-shareholder contributions as follows: "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." Thus, SALT incentives meet the CB&Q factors and qualify as non-shareholder contributions to capital.

DISCUSSION:

BACKGROUND

Tax incentives are used by many state and local governments to induce businesses to relocate to the community or to expand existing operations and investment. SALT inducements may include one or more of the following: tax rate reductions, tax abatements, tax credits, exemptions from income or property tax, and tax credits for the creation of additional local jobs. Specific qualifications and application procedures vary with each incentive. Taxpayers generally treat such SALT incentives as reductions of state and local tax expense for federal income tax purposes.

Taxpayers have argued that a SALT incentive should be viewed as a deemed payment to the taxpayer by the state or local government in the amount of the incentive, coupled with a payment of the tax by the taxpayer in the same amount as the incentive. Under this approach, the corporation claims a deduction for the full, unabated, or otherwise unreduced local tax liability under I.R.C. § 164. The taxpayer also reports an amount equal to the incentive amount as I.R.C. § 61 income. Thus far, the proposed increase in deductions exactly offsets the proposed increase to income. However, taxpayers further assert that the tax incentive amount is also excludible from income as a contribution to capital under I.R.C. § 118, which reduces the basis of property in accordance with I.R.C. § 362(c). In the case of land and other non-depreciable property, taxation of the deferred income could be postponed indefinitely, as there will be no offset resulting from the reduced basis until the property is disposed of in a taxable transaction. For buildings and other depreciable property, the tax benefit is recaptured over the depreciable life of the property, as the depreciation expense allowable each year is reduced due to the reduced basis in the property. This strategy was addressed by Coordinated Issue Paper (CIP) LMSB-04-0408-023, State and Local Location Tax Incentives, effective May 23, 2008.[1] The taxpayers' position described herein is based on protests and arguments presented to Appeals regarding this issue. The CIP and, consequently, the Appeals Settlement Guidelines (ASG) do not address the treatment of credits that are refundable, transferable, or provided in return for specific consideration, such as services, property, or the use of property.

The SALT CIP defines a SALT incentive as any tax reduction which is accorded a taxpayer who agrees to locate in, remain in, or expand its operations in a particular area, to create additional jobs in a particular area, or otherwise to invest in or remain in a particular area. The SALT CIP does not address refundable or transferable credits. The SALT nonrefundable incentives as discussed in the CIP will be addressed in this ASG in two major categories: (1) noncredit incentives and (2) credit incentives.

[1] The CIP can be reviewed by visiting the IRS Website at: http://www.irs.gov/businesses/article/0,id=183193,00.html.

(1) Noncredit Incentives

A noncredit incentive typically is an exemption or abatement of a tax. Cases seen in Appeals thus far dealing with noncredit incentives have involved real property and/or some type of statutory incentive. Below is a general description of the fact patterns associated with each type of noncredit incentive.

Real Property Tax Incentives

A real property tax incentive usually involves a bilateral agreement negotiated by taxpayers with a local economic development authority. It generally requires that taxpayers

- invest a certain dollar amount in a capital asset in a designated area
- complete an application prior to receiving the incentive
- receive approval by a state or local authority
- employ a certain number and/or type of employees, and
- submit annual reports.

A typical scenario is where a city offers to exempt the corporation from paying property taxes on a building for 10 - 15 years. In return, the corporation builds in a designated area and maintains a certain number of employees at that site. This is usually accomplished in one of two ways, either taxpayers: (1) receive a bill for the taxes associated with that building and then the incentive portion is abated; or (2) are never billed for the incentive portion of the taxes.

Statutory Tax Incentive

For purposes of this ASG, the statutory category, includes nonrefundable incentives that are statutory in nature. Unlike the real property tax incentives, a specific agreement is not required to be negotiated with state or local authorities for this type of incentive. To receive this incentive, the taxpayer typically must complete the appropriate form (usually as part of the state return or local business tax return) in a timely fashion with the appropriate information. If the taxpayer meets the requirements set forth by statute, the corresponding tax will be reduced. The taxpayer is not required to make the requisite investments, but if these investments are made, there is a statutory provision obligating the taxing authority to provide the incentive.

An example of this type of incentive is the inventory tax incentive in the form of free port exemptions. These are offered by some local tax authorities in order to promote trade. Qualifying materials and products are exempted from property/inventory taxes. The state code provides for the exemption and defines the types of property: The exemption must be approved by the voters in each city or municipality, and the exemption is specifically provided to induce companies to locate or maintain a presence in the local area. To claim the exemption, the taxpayer must file an application with its Business Personal Property Tax Return annually. The property tax is never assessed by the corresponding local or state authority and is never paid by the taxpayer.

Another example of this type of incentive is the state premium tax incentive. This type of incentive is offered by some states to insurance companies that invest in capital assets in their state. In return for this investment, the state reduces the tax paid by the insurance company on premiums sold in its state. The statutory rate is reduced as a function of the amount invested. The taxpayer files a form with its state tax return and calculates the tax using the reduced rate.

(2) Credit Incentives

As opposed to a nonrefundable incentive, which is a direct reduction in the tax assessed or a statutory reduction in the tax rate, a nonrefundable credit typically requires the calculation of a tax credit which is then applied to a tax liability. Cases seen in Appeals have been divided into two types: (1) credit incentives with a required capital investment and (2) credit incentives without a direct requirement for capital investment. Below is a general description of the fact patterns associated with each type of credit incentive.

Nonrefundable credits with capital requirements

Salary Credit

A common type of nonrefundable credit with capital requirements is the nonrefundable salary credit. This type of incentive allows a credit to be claimed against the net state business tax imposed on gross receipts. The credit is equal to a percentage of the amount paid by the company in salaries to qualifying employees who are covered by State unemployment compensation provisions. A bilateral agreement and a capital investment are usually required. The dollar amount of the capital investment determines the percentage of the salaries that is eligible for the credit. The taxpayer pays the full salary and calculates the credit on a separate form as part of the state return. The credit is applied to the tax liability and can reduce the liability to zero, but is not refundable or transferable. In some cases, the credit can be carried forward to subsequent periods.

Investment Tax Credits and Sales Tax Credits

Other nonrefundable credits requiring capital outlay include investment tax credits and sales tax credits. Investment tax credits are based on the amount invested by taxpayers in qualifying capital assets (e.g., state bonds) and are applied to reduce taxpayers' state tax liability. Sales tax credits are generated from the purchase of building materials and other supplies used to construct new assets or refurbish existing assets. The sales tax paid on these capital intensive assets results in a credit against state tax liability. The level of negotiation and inclusion in economic development incentive packages varies by case.

Nonrefundable salary credits without capital requirements

This type of credit incentive works the same as the nonrefundable salary credit with capital requirements except there is usually no agreement and no direct requirement to invest in a capital asset. If the taxpayer has qualifying employees in a designated area and completes the applicable forms timely, the credit is approved. This credit is also offered in conjunction with the real property tax incentive as part of an incentive package.

LEGAL ANALYSIS

ISSUE 1: Whether the receipt of state or local SALT incentives by a taxpayer, exclusive of refundable credits, (1) gives rise to gross income under I.R.C. § 61, (2) constitutes a contribution to the capital of a corporation by a non-shareholder under I.R.C. § 118(a), and/or (3) reduces the corporation's basis in property under I.R.C. § 362(c)?

The primary question is whether the substance of this transaction is a payment in kind by the taxing authority which is then used to pay the taxpayer's tax, resulting in a taxable event. There are currently no court cases directly on point regarding whether the receipt of SALT incentives creates gross income within the meaning of I.R.C. § 61. Gross income includes items of income from any source and in any form. I.R.C. § 61(a). The Supreme Court expanded the general concept of gross income to encompass all "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955). In addressing the "accession to wealth" standard, there is no question taxpayers are better off locating their facilities within jurisdictions offering tax incentives as opposed to jurisdictions which do not offer incentives. These incentives can be viewed as a reduction of overall operating costs (reduction of taxes) or as a subsidy for a capital outlay (land, buildings, equipment, etc.).

Treas. Reg. § 1.61-1 states: "Gross 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. Income may be realized, therefore, in the form of services, meals, accommodations, stock, or other property, as well as in cash." I.R.C. § 61 lists the more common items of gross income. For purposes of further illustration, Treas. Reg. § 1.61-14 mentions several additional miscellaneous items of gross income not listed specifically in I.R.C. § 61. Thus, with respect to relief from the payment of taxes, Treas. Reg. § 1.61-14(a) specifically states: "Another person's payment of the taxpayer's income taxes constitutes gross income to the taxpayer unless excluded by law." As noted, the regulations state that relief from the payment of a tax liability is a realized accession to wealth that constitutes income within the meaning of I.R.C. § 61.

Taxpayers have referred to non-precedential guidance issued by the IRS National Office as evidence that gross income potentially arises where a tax benefit is provided as consideration for a service. See, e.g., CCA 2002-27-003 (ruling that property tax abatements received by senior citizens as an inducement to work in volunteer programs in Massachusetts were determined to constitute gross income); CCA 2003-02-045 (ruling that property tax exemptions offered to volunteer emergency responders in recognition of services performed by the volunteers represented an in-kind payment for services and constituted taxable income to the recipients). While these are not relied upon for precedent and do not carry any weight in litigation, the rationale used by the Service can be examined and compared to taxpayers' arguments.

Another argument proposed by taxpayers relates to the application of various tests to determine whether or not an entity possesses the status of a Real Estate Investment Trust ("REIT"). To qualify as a REIT per I.R.C. § 856(c)(3)(E), the entity must draw at least 75 percent of its gross income from a variety of sources. One of the permissible sources from which gross income can be drawn is abatements of real property tax. There has been no guidance published as to what constitutes abatements of real property tax, as provided for in I.R.C. § 856(c)(3)(E). The REIT provisions, while they serve to define an eligible entity for income tax purposes, have no effect on the definition of gross income under I.R.C. § 61.

Compliance asserts that when a taxpayer is entitled to a tax abatement, credit, deduction, rate reduction, or exemption, the taxpayer generally is not regarded as realizing an accession to wealth which results in gross income. A state or local tax benefit of this type is applied against the taxpayer's current or future state tax liability, and is treated for federal income tax purposes as a reduction or potential reduction in the taxpayer's state or local tax liability. See Rev. Rul. 79-315, 1979-2 C.B. 27 (holding that, if all or a portion of a tax rebate is credited against tax due for a taxable year, the amount credited is: (1) treated as a reduction of the outstanding liability; and (2) neither included in income nor allowable as a deduction under I.R.C. § 164).[2]

Taxpayers distinguish Rev. Rul. 79-315, which involved legislation enacted by the State of Iowa to provide for individual income tax rebates for 1978 taxes. The legislation treated every individual as having made an additional payment of Iowa state income tax for the individual's tax year beginning in 1978. The deemed payment resulted in an overpayment of tax for 1978, thereby giving rise to a cash refund or tax credit. At issue was whether the rebates of Iowa income tax received by individuals were includable in their gross income under I.R.C. § 61. The IRS determined that the law was merely a way of effecting an across the board statutory decrease in the tax liability of each

[2] Revenue rulings are considered precedent by the Service and persuasive (but not binding) authority by courts.

individual taxpayer and, as a result, decided that the credit was not includible in income or deductible under I.R.C. § 164 as state income tax paid. Taxpayers argue that the Iowa income tax credit applied to every individual taxpayer and operated as a generic statutory decrease in each individual's tax liability. Taxpayers contrast this with the SALT tax incentives which were offered to induce the taxpayer to expand its operations, promote economic development, and make capital investments within the states in order to promote the requisite economic development activity being sought. Taxpayers assert that without the requisite economic development and investment activity, SALT incentives would not have been forthcoming.

In the CIP, Compliance cites Snyder v. Commissioner, T.C. Memo. 1998-320, vacated, 894 F.2d 1337 (6th Cir. 1990)(unpublished opinion), in support of the principle that SALT incentives are reductions in tax liability, not an accession to wealth. In Snyder, Northfield Park Associates ("NPA"), an Ohio partnership that operated a racing track, completed qualifying capital improvements which entitled it to a tax reduction. Generally, the state tax was based on a percentage of NPA racing wagers. However, the state provided for a tax reduction to holders of horse-racing permits who made certified capital improvements to their racing facilities, in the amount of 0.5% of the total amount wagered, continuing for six years or until the total reduction reached 70% of the cost of the certified improvements. The Service initially argued, and the Tax Court agreed, that the tax reduction was includible in income in the taxable year in which the state racing commission certified NPA's capital improvement costs. Id.

Before Snyder reached the Sixth Circuit Court of Appeals, the Service acknowledged that its prior position regarding the tax reductions was erroneous and agreed with the taxpayers that the proper treatment of the tax reduction was simply "to reduce the deductions available to [the partnership] for its pari-mutuel tax obligations, which reduced deductions accrue as those taxes become due." Id. The Sixth Circuit agreed with this analysis. The court noted that this case "does not involve any right on the part of [NPA] to receive an amount of money from the State of Ohio; it simply involves a right to start paying the state less in taxes than would have to be paid in the absence of the right." Id. The court held there was no "income" from the State of Ohio for the partnership to accrue. Id. Compliance asserts that similarly, in the case of nonrefundable SALT incentives, the taxpayer does not have a right to receive an amount of money that would result in income for Federal tax purposes. The SALT incentives reduce the amount of tax imposed, thereby, reducing the amount payable. The fact that SALT incentives operate to reduce the amount of tax that the taxpayer owes the local jurisdiction is a critical point. While cancellation of an obligation that is due may result in gross income, see, e.g., Treas. Reg. § 1.61-12(a), the taxes subject to the SALT incentives are never due and payable; rather, the SALT incentives operate to reduce the amount of tax that the taxpayer owes the local jurisdiction.

Taxpayers point out that the Sixth Circuit's unpublished opinion in Snyder, on which the Government relies, has never been cited as authority by any court, inside or outside of the Sixth Circuit. Taxpayers argue that the thorough analysis by the Tax Court in Snyder, in which the Government argued, and the Tax Court agreed, that the incentives represented income to the taxpayer, coupled with the limited discussion and analysis provided in the unpublished Sixth Circuit's opinion, actually supports the conclusion that incentives, in the form of tax credits, are properly includible in income.

Compliance also cites HMW Industries, Inc. v. Wheatley, 504 F.2d 146 (3d Cir. 1974), as case authority confirming that the proper treatment for incentives is a reduction in tax. In HMW Industries, the Virgin Islands made "non-taxable subsidy" payments, equal to a percentage of taxes previously paid to the Virgin Islands, to certain businesses to induce them to locate and remain in the Virgin Islands. The court considered whether such payments made to a corporation were non-shareholder contributions to capital or simply tax rebates resulting in a net reduction of taxes. The court concluded that the subsidies were reductions in tax, not capital contributions. 504 F.2d at 152-55.

Taxpayers assert that the "non-taxable subsidy" in HMW Industries is distinguishable from the tax incentive payments at issue because it specifically provided for an outright, across the board 75% reduction in income tax liability. In contrast, taxpayers further assert tax incentives are not mere generic reductions to a taxpayer's tax liability but represent inducement payments to expand taxpayer operations or make capital investments to foster economic development within the states, including creating jobs in the area as well as investing in the local economy.

Details regarding the mechanics of the subsidy provided in the appeal to HMW Industries indicate that the case did not involve a generic reduction in the recipient's tax liability. See id. at 151. Legislation establishing the subsidy required qualifying corporations to make certain specified types of new investments. Like the SALT incentives, the subsidy provided for in Act No. 224 Virgin Islands Sessions Laws indicates the intent to "extend such inducements and render such aid as will encourage persons, firms and corporations to establish and develop new business enterprises; to make additional investment capital available to new and existing business; to promote tourism and the building of hotels, guests houses and housing projects." Id.

Taxpayers have cited Watervliet Paper Co. v. Commissioner, 16 B.T.A. 604 (1929), and Consolidated Edison Co. of New York, Inc. v. United States, 10 F.3d 68 (2nd Cir. 1993), in support of the argument that, in certain circumstances where a taxpayer has provided services, property or the use of property, it may be appropriate for the taxpayer to recognize income and to have satisfied a tax liability by a payment in kind.

In Watervliet, the village offered to pay the taxpayer's local taxes if the taxpayer agreed to connect its power plant with the village's water mains in order to provide power and water to be used for local fire protection. The taxpayer received the tax abatements from the village in exchange for making the requisite capital investment to connect the power plant with the water mains, keeping all the pipes and connections in good repair so that fire protection could be provided by the village when needed, and furnishing the water required under contract. The court determined that the tax abatement was includible in gross income, although it held that the Commissioner's treatment (excluding the abatements from income and disallowing any offsetting deduction) reached the same result as including the abatements in income and allowing an offsetting deduction for taxes paid. 16 B.T.A. at 604.

In Consolidated Edison, the taxpayer received a discount from the city in exchange for prepayment of its real property taxes. The discount was equal to the approximate amount needed to make the taxpayer whole for its cost of borrowing the funds to make the prepayment. The city did not reduce the company's underlying property tax liability. The fact of prepayment accelerated the due date of the tax to the date of the payment. The prepayment discount was characterized to be a partial satisfaction of the taxpayer's unreduced tax liability; a pre-existing obligation was therefore paid in full rather than forgiven in part. The prepayment discount was gross income, but it was not interest income. 10 F.3d at 68.

Apart from Consolidated Edison, the common element among the previously discussed cited materials is that when the state or local tax benefit is provided in exchange for specific services, substance will control over the form of the transaction and the taxpayer will be treated as having received an in-kind payment from the taxing jurisdiction. This in-kind payment is then used to satisfy the taxpayer's tax liability. The transaction at issue in Consolidated Edison was in form, as well as in substance, a payment from the taxing jurisdiction to the taxpayer, which was then used to satisfy a part of the taxpayer's tax liability. See id. There was no need to recharacterize the transaction because the court held the taxpayer to the form of its transaction. The taxpayer received a discount from the city in exchange for prepayment of its real property taxes; the city did not reduce the company's underlying property tax liability. Consequently, Consolidated Edison does not support a proposition that a tax incentive in the form of a reduction in computing tax liability should be recharacterized as an in-kind payment from the taxing jurisdiction. Rather, the case shows that when there is an in-kind payment in form and substance, a taxpayer has income absent an applicable exclusionary provision. Consolidated Edison is also distinguishable, as in Watervliet, in that the tax reduction was provided in return for a specific quantifiable benefit provided to the city, not as an incentive for an activity that had incidental public benefits. See id.

In Watervliet, the court directly addressed the service element:

> Certainly, under the statute, taxes are allowable deductions and we do not see why the mere fact that they were paid by services rendered by the petitioner would in any way prevent their deductibility. On the other hand, the payment for services would constitute a part of petitioner's gross income. If the town had paid for the services and the petitioner had used these, or equivalent, funds in satisfying the taxes which were assessed, it could hardly be argued that the former did not constitute income and the latter a deduction.

16 B.T.A. at 604. The payment for services element was instrumental in determining that abated taxes constitute income. Taxpayers argue that the Watervliet decision applies to both activities and services. However, activities were not addressed by the

court, just services. The same holds true for CCA 2002-27-003 and CCA 2003-02-045 cited by taxpayers to illustrate that services rendered by senior citizens and emergency response workers resulted in taxable income. In contrast, the making of capital improvements that qualified the taxpayer for a state tax reduction in Snyder, 894 F.2d at 1337, and the actions that qualified the taxpayer for the tax location incentives in HMW Industries, 504 F.2d at 146, are "activities" that did not result in gross income. Those situations did not involve the provision of services to the taxing jurisdiction in exchange for tax incentives.

Another possibility for classifying tax incentives as income would be to accept that the SALT incentive represents a "relief of liability." Certain tax incentives and credits require the taxpayer to maintain prerequisite hiring levels, capital investments and other criteria negotiated as part of the tax incentive agreement on an annual basis. The taxpayer certifies annually that these requirements have been met. One could argue a tax liability is being relieved in return for a location activity. Taxpayers also argue that Treas. Reg. § 1.61-14(a), which provides that "another person's payment of the taxpayer's income taxes constitutes gross income to the taxpayer," supports the inclusion of tax abatements/exemptions in I.R.C. § 61 gross income. In Treas. Reg. § 1.61-14(a), the person whose taxes are being paid has an established liability for those taxes. In the case of tax abatements and/or exemptions, no such liability exists because those incentives are reductions in computing the amount of tax liability imposed by the taxing jurisdiction.

In addition to the premise that gross income is generated when a tax expenditure/liability is reduced or eliminated by the taxing authority as a result of the taxpayer providing services to the taxing jurisdiction, taxpayers have included another category, activities performed, as qualifying as I.R.C. § 61 gross income. It could be construed that in return for property tax abatements/exemptions, the taxpayer performs a type of service or activity. They agree to locate or maintain a facility and to create or provide new jobs. These actions are undertaken in return for relief from a property tax liability. If the location or retention of a facility and/or the creation of jobs is viewed as a service rendered or an activity performed in exchange for compensation, then the generation of I.R.C. § 61 gross income is likely. However, if the property tax abatements/exemptions are viewed outside the realm of a service or activity for compensation, the generation of I.R.C. § 61 gross income is unlikely. Also, as discussed later, this would diminish the taxpayer's position that this is a contribution to capital by the transferor in return for only indirect speculative benefits. Whether the receipt of SALT incentives qualifies as a contribution to capital is addressed as part of Issue 3.

If SALT incentives are determined to qualify for exclusion as a non-shareholder contribution to capital under I.R.C. §118(a), then a basis reduction is required per I.R.C. §362(c). Compliance did not dispute this requirement in the CIP, but rather indicated that it was not relevant because the SALT incentives do not qualify for exclusion as a non-shareholder contribution to capital.

<u>ISSUE 2:</u> Whether SALT incentives are deductible as a tax under I.R.C. § 164 if paid or accrued during the taxable year?

It is important to note that the analysis of the I.R.C. § 164 issue is intertwined with, and cannot be separated from, the analysis of the issue regarding gross income. If I.R.C. § 61 gross income is generated, this deemed income must be offset with a corresponding deemed expenditure to create the current tax benefit desired by the taxpayer. It is, as though the state or local government had paid the incentive in cash, which the taxpayer then used to satisfy its tax liability. Taxpayers have claimed an I.R.C. § 164 current deduction as opposed to reducing a capital asset for the SALT incentives offset.

In fact, the authority of the <u>Watervliet</u> case cited in support of a deduction for a deemed tax expenditure must be seriously questioned in light of the 1984 Congressional codification of the economic performance doctrine in I.R.C. § 461(h).

I.R.C. § 164(a) allows a deduction for certain taxes, including income taxes, real property taxes, and personal property taxes imposed by local and state governments, that are paid or accrued during the taxable year. In order to be entitled to a deduction under I.R.C. § 164, an accrual basis taxpayer must demonstrate that the tax liability to be deducted has accrued within the meaning of I.R.C. § 461. Under I.R.C. § 461, an expense is deductible for the taxable year in which all the events have occurred that determine the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred. Treas. Reg. §§ 1.461-1(a)(2); 1.461-4(a).

With respect to state and local taxes, economic performance occurs as the tax is paid to the governmental authority that imposed the tax. Treas. Reg. § 1.461-4(g)(6). The sole exception to this general rule permits a tax liability to be taken into account in the taxable year before the taxable year during which economic performance occurs under the “recurring item exception” of Treas. Reg. § 1.461-5. In the event that the recurring item exception is properly adopted, all events must have also occurred that determine the liability. Treas. Reg. § 1.461-4(g)(8), Example (8). Under the recurring item exception, a liability will be treated as incurred for a taxable year if economic performance has occurred on or before the earlier of the filing of a timely return or the 15th day of the 9th calendar month after the close of the taxable year. In addition the all events test must also be satisfied. Treas. Reg. § 1.461-5(b).

Thus under either the general rule or the recurring item exception, the regulations make clear that economic performance with respect to taxes can occur only in circumstances when taxes are actually paid. Under the general rule, a deduction for taxes may only be allowed “as the tax is paid” while under the recurring item exception the economic performance of paying the tax must occur within 8½ months after the close of the taxable year. Treas. Reg. §§ 1.461-4(g)(6)(i); 1.461-4(g)(8), Example (8); 1.461-5(b). Under either rule, satisfaction of the all events test to determine the fact of liability is also required. Treas. Reg. § 1.461-4(a).

The preamble accompanying Treas. Reg. § 1.461-4(g) further confirms that an actual payment of taxes is required to satisfy the economic performance test. The reason for the payment rule was explained as follows:

> The regulations provide that economic performance for a tax liability occurs as the tax is paid to the governmental authority that imposed the tax. Commentators argued that the lien date or assessment date should be retained as the time economic performance occurs for real property taxes.
>
> The payment rule is necessary for tax liabilities because a prolonged period may elapse between the lien or assessment date and the date the taxes are paid. The Service and the Treasury Department believe that in these cases treating economic performance as occurring on the lien or assessment date would overstate the true cost of the expense and, consequently, fail to implement the principles of economic performance. Therefore, the final regulations retain payment as the time economic performance occurs for real property taxes.

T.D. 8408, 1992-1 C.B. 155, 161.

Treas. Reg. § 1.164-1(a) further provides that taxes are deductible only by the person upon whom they are imposed. Many of the taxing authorities invoice the taxpayer for the post incentive amounts. Since the abatements and exemptions are a reduction of the property tax liability, the taxpayer is not actually liable for the abated and exempted amounts. The abated and exempted property taxes are "not imposed" on the taxpayer, nor have the abated and exempted property taxes established the fact of liability in order to satisfy the all the events test of I.R.C. § 461(h)4). The deduction of deemed tax payments attributable to abated and exempted taxes is thus precluded by I.R.C § 461 and the regulations thereunder.

Taxpayers have argued that the tax liability exists but for the performance of an activity (i.e., capital investment); that the annual abatement of taxes represents a series of deemed payments by the taxing authority to the taxpayer to satisfy the tax liability; and that certain annual requirements must be met by the taxpayer to retain the incentives/credits. As of the close of the tax year, the taxpayer has full knowledge of whether these annual requirements have been met. All the events have occurred which determine the fact of the liability and the amount of the liability can be determined with reasonable accuracy. Notwithstanding taxpayers' argument, in those cases where the SALT incentives requirements have been met, the tax liability is the post abatement/exemption amount. With respect to the requirement that a liability exists, in the case of SALT incentives, the taxpayer is not liable for and is never called upon to pay the SALT incentives amount.

For purposes of determining whether an accrual basis taxpayer can treat the amount of any liability as incurred, the all events test is met no earlier than the taxable year in which economic performance occurs with respect to the liability. Treas. Reg. § 1.461-4(a)(1). As stated earlier, with respect to state and local taxes, economic performance generally occurs as the tax is paid to the governmental authority that imposed the tax. Treas. Reg. § 1.461-4(g)(6). In the instant case, the taxpayer does not pay, and is never liable for, any state or local taxes in excess of the amount remaining after all applicable deductions, credits, exemptions and abatements have been subtracted. Thus, only the amount for which the taxpayer is liable after application of the SALT incentives is deductible.

Hurd Millwork Corp. v. Commissioner, 44 B.T.A. 786 (1941), acq. in result only, 1941-2 C.B. 7, supports the conclusion that only the post SALT incentive amount is deductible. In Hurd Millwork, the manufacturing facility of a corporation was destroyed by fire. To assist and encourage the taxpayer to rebuild, the city passed a resolution pursuant to which the city would pay the company's real estate taxes for the year of the fire and three subsequent years. Nevertheless, the taxpayer accrued and deducted the full amount of the real estate taxes which would have been payable, absent the resolution, for the year of the fire. The court held that the taxes were not deductible, because the resolution was in place and the taxpayer's liability was extinguished prior to the end of the year. The court reasoned that the taxpayer's "accrued liability for 1936 real estate taxes would never be enforced against it, that is, that petitioner would never have to pay such taxes out of its own operating revenues." 44 B.T.A. at 793. Likewise, the SALT incentives considered herein are not deductible, because the taxpayer never is liable for and never will pay the SALT incentives amount.

Generally, a state tax credit, rebate, or exemption, to the extent that it can be applied only against the recipient's current or future state tax liability, is not treated as a *payment* from the state and is not deductible as a *payment* of state tax under I.R.C. § 164. See HMW Industries, 504 F.2d at 146; Rev. Rul. 79-315. Taxpayers have pointed to non-precedential guidance to explain the circumstances under which exceptions to this general rule may be made, and note that, in certain situations, in order to reflect the substance of a transaction and to treat similarly-situated taxpayers fairly, a reduction in state tax liability may be re-characterized, for federal tax purposes, as a deemed payment by the state to the taxpayer. See CCA 2002-27-003 and CCA 2003-02-045. This treatment may be appropriate, for example, when a credit, abatement, or similar item is provided in return for the provision of services, the use of property, or the transfer of property. Such a re-characterization may involve deeming the taxpayer to have made an equal, offsetting payment to the state, in satisfaction of the taxpayer's tax liability unreduced by the credit, and this offsetting deemed payment to the state may be deductible as a payment of tax if it otherwise qualifies.

When the taxes are credited or abated as a means of providing incentives for the performance of a desired service, there is ample guidance allowing taxpayers an I.R.C. § 164 deduction for state or local taxes. In these circumstances, the value of the service provided determines the amount applied as a reduction to an existing liability.

Court cases have provided limited analysis on this point because the I.R.C. § 61 income recognized for the tax credit or abatement offsets the benefit of the I.R.C. § 164 deduction in the same exact amount. Thus, the usual approach by taxpayers simply has been to ignore the additional income item and forego the offsetting deduction amount (exclusion/no deduction). See Watervliet, 16 B.T.A. at 604.

In Consolidated Edison Co. of NY v. U.S. (10 F.3d 68 (2nd Cir. 1993)), the taxpayer participated in a prepayment plan under which it paid its real property taxes for the year well in advance of the due date. 10 F.3d at 68. In accordance with the prepayment incentive plan, the taxpayer received a discount on the amount of real property taxes actually owed. The taxpayer deducted the undiscounted amount of its real property taxes from its gross income under I.R.C. § 164. The court held that the taxpayer was entitled to deduct the prepaid amount and the discount amount as property taxes because the entire amount constituted part of the taxpayer's tax obligations. Id. at 74. Unlike the typical SALT abatement or exemption which reduces the amount of tax imposed, the real property taxes for Consolidated Edison fully accrued by the end of the relevant tax years. The Second Circuit Court of Appeals affirmed the district court's decision, upholding the basic concept that an actual transfer of taxes need not occur in order for an I.R.C. § 164 deduction to be appropriate. Id.

In Service Center Advice ('SCA') 2002-25-030[3] cited by taxpayers as supporting the principle that taxes need not actually be paid to be deductible, the Government determined that employees could claim a deduction for state income taxes paid by their employer on their behalf. The employer included the tax payments as wages on the employees' Forms W-2. In this situation, the employer's payment of the employees' taxes was treated as a payment of compensation to the employees followed by the employees' payment of federal and state taxes. The circumstances addressed in the SCA are distinguishable from the SALT incentives considered herein, not only because the employees remained directly liable to the taxing authority for the full amount of the tax, but more particularly because the payment of state taxes by the employer was compensation for services rendered by the employees. Another distinguishing point is the actual payment of the taxes was made by a third party (the employer) as opposed to the SALT strategy, which relies on a deemed payment argument. In the SALT strategy there is typically no actual payment of the taxes in the amount of exemption/abatement amounts.

[3] SCA 200225030 is provided for illustrative purposes only to respond to taxpayer assertions. It is not relied upon as precedent.

<u>ISSUE 3:</u> Whether SALT incentives received by a taxpayer, if determined to represent gross income, are excludible as a non-shareholder contribution to capital under I.R.C. § 118(a)?

Before the I.R.C. § 118 exclusion can be considered, one must have I.R.C. § 61 gross income. Therefore, I.R.C. § 118 is only applicable to amounts included in gross income.

I.R.C. § 118(a) provides an exclusion from gross income for, in the case of a corporation, any contribution to the capital of the taxpayer.

Treas. Reg. § 1.118-1 provides, in part, that I.R.C. § 118 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.

While I.R.C. § 61(a) provides a broad definition of "gross income" and the Supreme Court has repeatedly emphasized the 'sweeping scope" of this section, the Supreme Court has also emphasized the corollary, namely, the "default rule of statutory interpretation that exclusions from income must be narrowly construed." <u>Commissioner v. Schleier</u>, 515 U.S. 323, 328 (1995). Therefore, as I.R.C. § 118(a) is an exclusionary provision, it must be narrowly construed in determining whether incentives qualify as contributions to capital.

The statutory term "contribution to capital" is not expressly defined in the Internal Revenue Code, the regulations, or the legislative history of I.R.C. § 118(a). The brief legislative history of I.R.C. § 118(a) indicates that the exclusion was intended to be a codification of the existing law that had developed through administration and court decisions. H.R. Rep. No. 1337, 83d Cong., 2d Sess. 17, A-38 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 18 (1954).

The first major case addressing non-shareholder contributions to capital was <u>Edwards v. Cuba Railroad Co.</u>, 268 U.S. 628 (1925). In <u>Cuba Railroad</u>, the Supreme Court held that subsidies paid by the Cuban government to the taxpayer in proportion to the mileage completed were a contribution to the capital of the recipient taxpayer rather than taxable income. Id. In this case, the Cuban government granted the taxpayer, the owner of a railroad in Cuba, subsidies comprised of money, land, buildings, and equipment pursuant to contracts under which the taxpayer agreed to construct and operate a railroad on certain specified routes and to provide the government with reduced rates and other benefits. In determining that the money subsidies were a contribution to capital of the recipient taxpayer, the Court said:

> The subsidy payments were proportionate to mileage completed; and this indicates a purpose to reimburse plaintiff for capital expenditures. . . . Neither the laws nor the contracts indicate that the money subsidies were to be used for the payment of dividends, interest or anything else properly chargeable to or payable out of earnings or income.

Id. at 632.

The Supreme Court then decided three cases – Detroit Edison v. Commissioner, 319 U.S. 98 (1943), Brown Shoe Co. v. Commissioner, 339 U.S. 583 (1950), and United States v. Chicago, Burlington & Quincy R.R. Co., 412 U.S. at 401 – addressing the question of whether taxpayers could depreciate assets contributed by non-shareholders and/or assets purchased with funds contributed by non-shareholders. The rulings in these cases impacted the definition of a non-shareholder contribution to capital and provided guidance concerning capital contributions and income received in exchange for the performance of services.

In Detroit Edison, the Court held that payments made by prospective customers to an electric utility to cover the cost of extending the utility's facilities to the customers' homes were part of the price of service and not contributions to capital. The Court found that the customers did not intend to make contributions to the taxpayer's capital and regarded the payments as the price of services, stating, "it overtaxes imagination to regard the farmers and other customers who furnished these funds as makers either of donations or contributions to the Company." Id. at 102.

In Brown Shoe Co., the Court held that payments to a corporation by community groups to induce the location of a factory in their community represented a contribution to capital. The Court reasoned:

> Since in this case there are neither customers nor payments for service, we may infer a different purpose in the transactions between petitioner and the community groups. The contributions to petitioner were provided by citizens of the respective communities who neither sought nor could have anticipated any direct service or recompense whatever, their only expectation being that such contributions might prove advantageous to the community at large. Under these circumstances the transfers manifested a definite purpose to enlarge the working capital of the company.

Id. at 591.

The distinction between Detroit Edison and Brown Shoe Co. is the expected benefit to the contributor, not how the funds were used. In Detroit Edison, the contributors were customers who expected to receive a direct benefit in the form of utility services for their payments. 319 U.S. at 98. In Brown Shoe Co., the contributors were not customers and expected only indirect speculative benefits. 339 U.S. at 583.

In the third case, CB&Q, the Court considered whether a taxpayer was entitled to depreciate the cost of certain safety-related improvements that had been required and funded by the Federal Government. 412 U.S. at 401. The Court held that the government subsidies were not contributions to the taxpayer's capital. Id. In CB&Q, the Court analyzed the Detroit Edison and Brown Shoe Co. cases to identify some of the characteristics of a non-shareholder contribution. Although in both cases the assets transferred were actually used in the transferee's business for the production of income, the Court found that the intent of the contributor in Brown Shoe Co. to make a contribution to capital in return for an indirect speculative benefit distinguishes that opinion from Detroit Edison where the transferor intended no contribution to capital. In CB&Q, the Court held that the government subsidies to the railroad for safety improvements were not contributions to the taxpayer's capital. Id.

If a SALT incentive is treated as an item of gross income, a taxpayer must show that it satisfies each of the five factors required under CB&Q to qualify for exclusion as a non-shareholder contribution to capital. The factors developed by CB&Q to identify contributions to capital (the "CB&Q factors") are as follows and are discussed in detail below:

a. The contribution must become a permanent part of the transferee's working capital structure;
b. The contribution must not be compensation for specific, quantifiable services provided by the transferee to the transferor;
c. The contribution must be bargained for;
d. The asset transferred must result in a benefit to the transferee commensurate with its value; and
e. The asset transferred ordinarily, if not always, will be used to produce additional income.

Id. at 413.

CB&Q Factors Discussion:

a. Factor One – Permanent Part of Working Capital:

SALT incentives are offered to induce taxpayers to locate or retain operations within the states and to engage in economic development activities within such states. The incentives provided often require an investment in capital assets to qualify for the incentive. The Court of Appeals in GM Trading Corp. v. Commissioner, 121 F.3d 977 (5th Cir. 1997), stated: "A payment to induce investment is the quintessential nontaxable contribution to capital." Id. at 981. In Brown Shoe Co., the cash received from various community groups was not specifically earmarked for capital asset acquisition. However, the Supreme Court reasoned that the payments were not for specific services, did not constitute gifts and, therefore, considered the intent of the payments was to enlarge the working capital of the company. 339 U.S. at 583.

Compliance asserts that even if a SALT incentive were treated as an amount paid to the taxpayer, it is generally not conditioned on the taxpayer's actual use of the amount to acquire capital assets, and thus does not become a permanent part of working capital. Compliance further asserts that in substance, the incentive is simply a recovery of expenses of operations. See Springfield Street Railway Co. v. United States, 577 F.2d 700 (Ct. Cl. 1978)(ruling state grants based upon excise tax liabilities were reductions in tax liability and not contributions to capital, even though taxpayer acquired capital assets with the grants). The essence of a capital contribution is that it is used to enhance the taxpayer's capital structure, and is not available for use as the transferee sees fit. Id. Payments cannot qualify as contributions to capital, where the payments "might be used for payment of dividends, of operating expenses, of capital charges, or for any other purpose within the corporate authority." Texas & Pacific Railway Co. v United States, 286 U.S. 285, 290 (1932). More recently, in United States v. Coastal Utilities, 483 F. Supp. 2d 1232 (S.D. Ga. 2007), aff'd, 514 F.3d 1184 (11th Cir. 2008) (per curiam) and CB&Q, 412 U.S. at 401, the courts have emphasized the intent of the contributor when making the transfer, abandoning the direct tracing or functional use test. The question is whether the contributor intended to make a contribution to capital or subsidize an operating expense?

Taxpayers assert that tax incentives awarded for investing in various facilities and other capital assets represent the functional prerequisite without which the state tax incentive would not be forthcoming. Taxpayers further assert that contributions, such as these tax incentives, represent a deemed payment in reimbursement of capital expenditures, and satisfy the first factor of the CB&Q test *per se*. See, e.g., Cuba Railroad, 268 U.S. at 628 (treating reimbursement of construction costs incurred by taxpayer in building railroad in Cuba as non-shareholder contributions to capital). Taxpayers further assert that the Government position that factor one of the CB&Q test is not satisfied because the SALT incentive deemed payment is not directly traceable to the purchase of capital assets is incorrect given the statutory and case law on this point.

The Supreme Court decision in Texas & Pacific Railway held that the amounts received by the taxpayer were not excludable as contributions to capital because their sole purpose was to guarantee the recipient a certain level of operating income, stating, "Here, [the payments] were to be measured by a deficiency in operating income, and might be used for the payment of dividends, of operating expenses, of capital charges, or for any other purpose within the corporate authority, just as any other operating revenue might be applied." 286 U.S. at 290. The payments were neither induced nor were measured by capital investments. As a result, the Court found that, in substance, the payments were nothing more than operating subsidies. Id.

In Springfield Street Railway, the taxpayer received annual statutory grants from the State of Massachusetts as an operating subsidy. 577 F.2d at 700. The court did not adopt the concept of direct tracing argued by Springfield. Instead, the court applied an intent-based approach. Since the underlying purpose of the grant money was to provide an operating subsidy and was neither conditioned upon use of the grant to acquire capital assets nor an inducement to invest, the grant money was not a contribution to capital even though the grant was used to acquire capital assets. Id.

Taxpayers argue an intent-based approach is expressly adopted by the regulations implementing the I.R.C. § 118/I.R.C. § 362(c) regime, which represents a codification of the contribution to capital doctrine as developed through case law. Specifically, Treas. Reg. § 1.362-2(a) provides: "Property deemed to be acquired with contributed money shall be that property, ***if any***, the acquisition of which was the ***purpose motivating the contribution***." Treas. Reg. § 1.362-2(a)(emphasis added by taxpayer). Excludable contributions may be received that, either in whole or in part, are not earmarked for, or directly traceable to, investment in property. Taxpayers assert this possibility is why Treas. Reg. § 1.362-2(b) establishes a default allocation mechanism. According to taxpayers, if all excludable contributions were specifically earmarked for and directly traceable to capital assets, there would never be a need for the elaborate default rule provided in the regulations promulgated to apply I.R.C. § §118 and 362(c). Taxpayers further assert that instead, there would be a strict dollar-for-dollar linkage between the payment and the investment, thereby rendering Treas. Reg. § 1.362-2(b), as well as Treas. Reg. § 1.362-2(a), superfluous.

Moreover, taxpayers point to Federated Department Stores v. Commissioner, 426 F.2d 417 (6^{th} Cir. 1970), nonacq., 1971-2 C.B. 1, where the court held that cash provided by a developer to an anchor store to induce it to construct and locate an outlet in a mall was excludable as a contribution to capital. This cash was to be received $200,000 per year over a 10-year period with no requirement as to how it would be spent by the taxpayer. The court found that the relationship between what the anchor store did and the benefits the developer sought were not so direct as to conclude it was a payment for services. 426 F.2d at 417.

Another question is whether the state and local taxing jurisdictions contribute any capital to the taxpayer? It appears that the purpose of the SALT incentives is to induce the taxpayer to invest in the local area and/or create jobs and the form of the incentives is to reduce the taxpayer's operating expenses. This being the case, the incentives do not become a permanent part of the taxpayer's working capital in the same way a contribution of land or cash used to purchase a capital asset does. Evidence of such treatment is demonstrated by the taxpayer claiming a current I.R.C. § 164 deduction for the SALT incentives.

Taxpayers argue that they must locate their operations within a specific jurisdiction to obtain the tax incentives and that the incentives are in substance a reimbursement for the cost of land, buildings, and equipment in locating their operations within the specified jurisdiction. If this is the case, it raises the question whether the proper treatment would be to offset the costs of these capital assets, instead of claiming a current deduction for taxes. The treatment proposed by the taxpayers is taxable income subject to the I.R.C. § 118 exclusion, a current deduction for state and local taxes, and a reduced basis for future sale or depreciation deductions.

b. Factor Two – Contribution Must Not be Compensation for Specific Services

Do the taxpayers generally provide specific, quantifiable services to the state and local taxing jurisdictions in exchange for SALT incentives? From the cited guidance, CCA CCA 2002-27-003 and CCA 2003-02-045 related to the establishment of I.R.C. § 61 gross income, an element of "services rendered" is required to generate gross income. If the location or retention of a facility and/or the creation of a job is determined to be a type of service rendered, the taxpayer would have difficulty in satisfying this factor under I.R.C. § 118 – the contribution can not be compensation for services rendered.

According to the taxpayers, in its most basic form, the second factor of the CB&Q test is aimed at distinguishing contributions to capital from compensation paid by the contributor for property or services rendered. 412 U.S. at 413. Taxpayers further assert that where the benefit to the contributor is only indirect, and the principal purpose of the contribution is to benefit the community as a whole, rather than the contributor, the second factor of the CB&Q test will be met. See Brown Shoe Co., 339 U.S. at 583; Detroit Edison, 319 U.S. at 98. Such a public purpose is in place with respect to the SALT incentives. As stated, the incentives are adopted to foster capital investment and job creation within the state, thereby leading to the enhancement of the economy as a whole. However, in Coastal Utilities, the court ruled that the universal support payments were income even though the general purpose was to benefit the public. 483 F. Supp.2d 1232 (S.D. Ga. 2007), aff'd, 514 F.3d 1184 (11th Cir. 2008)(per curiam). A general public benefit alone is not sufficient to meet this factor. The court reasoned:

> At the highest level of generality, all government spending should, theoretically, and at least indirectly, be for the purpose of benefiting the community. To decide a case such as this based on the most generalized expressed purpose of Congress would make virtually all government subsidies contributions to capital, except where the government received specific goods and services in return for the payments.

483 F. Supp. 2d at 1246.

Satisfaction of this factor alone, would not establish that the incentives are contributions to capital under I.R.C. § 118, particularly when it is questionable if the incentives satisfy the first factor articulated by the Supreme Court in CB&Q. For example, the Court in CB&Q acknowledged that the railroad did not provide services in exchange for the payments at issue and nevertheless found that the payments were not contributions to capital. 412 U.S. at 401.

c. Factor Three – Contribution Must be Bargained For

While some SALT incentives entail bargaining, satisfaction of this factor alone likewise is not determinative of whether the amounts constitute a contribution to capital. The level of bargaining varies with the type of incentive. Some are simply the result from the application of the state statutory tax provisions to the particular taxpayer involved. The rate reductions and credit amounts are established by statute. There is no indication of a bargaining process. These rate reductions and credits are available to all companies meeting the specific requirements who make the required investments/expenditures and file the appropriate forms. On the other hand, there are property tax incentives and credit incentives with associated capital investment requirements which usually require an application to secure the incentives. This results in a bilateral agreement, which involves some negotiation and an approval process. However, even in those cases requiring a bilateral agreement, the amount of the incentive that can be offered is typically fixed within a specified range allowing the local government to negotiate only within that range.

SALT incentives that do not result from any bargaining, but rather simply from the application of the state or local statutory tax provisions to the particular taxpayer involved would not meet this factor even if a SALT incentive were treated as an item of gross income.

Taxpayers assert that the purpose behind the third factor of the CB&Q test is a desire to ensure that the contribution is not the result of a unilateral transfer, as was the case in CB&Q, where the Supreme Court found the taxpayer's contribution to capital argument weakened by the fact that the railroad had no choice in receiving subsidy payments from the U.S. Government. Id. Taxpayers further assert, where an incentive is offered via statute on a formulary basis, choice to receive the incentive exists, and the spirit underlying the contribution to capital is preserved, then the third factor of the CB&Q test will be met.

Taxpayers refer to the language in Rev. Rul. 93-16, 1993-1 C.B. 26, to support their position regarding bargaining. In Rev. Rul. 93-16, the IRS held that a project grant by the Federal Aviation Administration (the "FAA") to a corporate owner of a public-use airport under the Airport Improvement Program was a non-shareholder contribution to capital under I.R.C. § 118(a). The grants were to be used for construction, hazard removal, acquisition or installation of air navigation aids and safety or security equipment, land acquisition, and to prepare and implement noise compatibility programs. The IRS determined that the FAA's motivation for making the grants was to benefit the public at large through safer and more efficient airports. In addition, the IRS examined the CB&Q factors and noted that the payments: (1) were used for development, planning and equipment purchases and, therefore, became a part of working capital; (2) were not made for the purchase of specific, quantifiable services because any services the government received as a result of the payments were incidental to their purpose; (3) were bargained for because they were highly sought after with certain meaningful conditions; (4) provided an economic value to the airport through improved safety and operations; and (5) increased public use of the airport's facilities and services and, thereby, generated additional income. Id.

Taxpayers propose that the tax incentives received do in fact meet the "bargained for" requirement present in the third factor of the CB&Q test. Taxpayers assert that unlike CB&Q, taxpayers have the ability to choose from numerous locations throughout the

United States in which to pursue their investment and economic development activities and taxpayers have a choice and control over whether to avail themselves of the incentives provided by the various communities. Taxpayers believe their choice and control represents the type of negotiations contemplated by the third factor of the CB&Q test.

In Coastal Utilities, the taxpayer posed a similar argument, indicating that because the taxpayer could choose to participate or not participate in the universal service program by simply declining to file the required studies or maintain the required network, the taxpayer argued the bargaining factor was satisfied. 483 F.Supp.2d at 1232. However, the court reasoned that the mere fact that a transferee may opt into a transaction does not indicate the presence of a bargaining process. Id.

The traditional meaning of "to bargain" means to negotiate over the terms and implies that there is a give and take on the part of the transferee and the transferor. Where the courts and IRS have found that a transaction satisfied the bargaining element, the parties have engaged in some type of negotiation. In Coastal Utilities, where the bargaining element was not considered satisfied, the amount of support received was fixed by orders and regulations. Id. This indicates that in order to meet the bargaining test, there must be meaningful negotiations by the transferee and transferor. The ability to opt into a transaction such as the statutory type of incentive does not satisfy the bargaining requirement.

d. Factor Four – Benefit Must be Commensurate with Value

This factor relates to the classification of the SALT incentive as either an operating expense – the form of the transaction – or as a capital asset. If classified as an operating expense, no asset exists – nothing is transferred and there is no value apart from the reduction of an operating expense. However, if classified as a capital asset, this supports an argument that a benefit has been received worth the value of the capital asset. Satisfaction of this element alone obviously is insufficient to qualify a SALT incentive as a non-shareholder contribution to capital.

In CB&Q, the Supreme Court inquired whether, after the transaction, the taxpayer was more valuable than if the transaction had never taken place. 412 U.S. at 401. The Court concluded: "[W]hile some incremental benefit from lower accident rates, from reduced expenses of operating crossing facilities, and from possibly higher train speed might have resulted, these were incidental and insubstantial in relation to the value now sought to be depreciated, and they were presumably considered in computing the railroad's maximum 10% liability under the Act." Id. at 414. In essence, the Court reasoned that even when a tangible item is contributed to a taxpayer, resulting in a benefit equal to the fair market value of the asset, the taxpayer must demonstrate that it becomes a more valuable corporation as a result of the asset transfer. Compliance asserts that SALT incentives, even if considered gross income, would not automatically constitute a benefit that enhances the value of the taxpayer by more than the amount of the deemed payment as required under CB&Q.

Taxpayers' position is that the incentives received are payments for separate consideration and, in turn, are economically identical to the transfer of cash by the state or local government to the taxpayer. Taxpayers assert the fourth factor of the CB&Q test is satisfied because, by definition, "cash payments are equivalent to their value." See TAM 92-38-007[4] (June 10, 1992)(holding that payments by a state to reimburse costs incurred by a taxpayer for training expenses at a new plant within the same state were a contribution to capital when these costs were start-up costs).

e. Factor Five – Must be Used to Produce Additional Income

This factor relates to the intent or motive of the transferor; whether the benefit to the transferor was direct or indirect, specific or general, certain or speculative. In CB&Q, the Supreme Court reasoned that the facilities were constructed primarily to improve public safety; the need of the railroad for capital funds was not considered in determining the amount of the contribution; the facilities were peripheral to its business and as a result did not materially contribute to the production of further income by the railroad. 412 U.S. at 401.

It is the taxpayers' position that the incentives received induce taxpayers to expand their operations and make further capital investment in various assets located within the states. Taxpayers further assert that all of these assets will materially contribute to the production of further income by taxpayers, thereby satisfying the fifth factor of the CB&Q test.

Compliance asserts that the SALT incentives do not produce additional income. Compliance cites CB&Q, where the Supreme Court premised its holding that the assets were not used for the production of additional income in large part on the fact that "the need of the railroad for capital funds was not considered." Id. at 414. Thus, according to Compliance, payments cannot qualify as contributions to capital where the payments "might be used for payment of dividends, of operating expenses, of capital charges, or for any other purpose within the corporate authority." Texas & Pacific Railway, 286 U.S. at 290; see also Springfield Street Railway, 577 F.2d at 700; Baboquivari Cattle Co. v. Commissioner, 47 B.T.A. 129, 1942, aff'd, 135 F.2d 114 (9th Cir. 1943).

Compliance reasons that the motivation of the transferor in making the payment is a crucial determinant of whether the payment constitutes a non-shareholder contribution to capital. This inquiry is factual in nature. If the payment is made in return for specific services, for example, the payments would not qualify as contributions to capital. Taxpayers may argue that the transferor's public benefit motivation is controlling even if the contributions constitute compensation for services or do not become a permanent part of the transferee's working capital structure. Compliance asserts that in situations

[4] TAM 92-38-007 is provided for illustrative purposes only to address points presented by the taxpayer. It is not relied upon for any precedential value.

where the transferor has dual motivation (e.g., obtaining services as well as providing a public benefit), such a transfer is not a contribution to capital. Compliance refers to the Supreme Court statement in the CB&Q opinion indicating contributions to capital are those transfers that are "made with the purpose, not of receiving direct service or recompense, but **only** of obtaining advantage for the general community, as in Brown Shoe Co. . . . ." 412 U.S. at 411 (emphasis added by Compliance).

Again, in the case of SALT incentives, the classification of the incentive as either an operating expense or a capital asset is essential in considering this factor. If no asset is transferred, income cannot be produced. However, if a capital asset is determined to have been transferred, the potential for production of additional income is high.

Contributor Motivation

Cases previously discussed have considered the intent of the contributor as a factor in determining whether the contribution represents a non-shareholder contribution to capital. See, e.g., Texas & Pacific Railway, 286 U.S. at 285; Springfield Street Railway, 577 F.2d at 700. Likewise, in Coastal Utilities, the district court analyzed whether subsidies received from the federal universal service high cost support program and the Georgia Universal Access Fund constituted income under I.R.C. § 61 or capital contributions under I.R.C. § 118(a) by focusing on contributor intent. 483 F. Supp.2d 1232 (S.D. Ga. 2007), aff'd, 514 F.3d 1184 (11th Cir. 2008).

More specifically, in Coastal Utilities, the court focused on the contributor's motivation in making a payment, not the functional use of the payment to determine whether payments constituted income or a non-shareholder contribution to capital. 483 F. Supp.2d at 1232. In addition to considering the CB&Q factors, the court found that the methods for calculating the subsidy amounts demonstrated the purpose of the subsidies was to supplement revenue. Universal service support payments are based on investment return, taxes, and a broad range of expenses (some of which are unrelated to capital investment) and not on a proposal to build new infrastructure or on the estimated cost of upgrading existing infrastructure. Accordingly, the court concluded that the payments were intended as supplements to Coastal's income, not capital contributions. The court stressed the intent or motive of the transferor and determined the tax character of the transaction by that intent or motive. In exempting corporations from these taxes, the states and localities expect to receive an indirect benefit in the form of increased jobs and economic development resulting from the capital investment made by the corporation. Id. While a capital investment may be required to receive the SALT abatement/exemption as in Coastal Utilities, the amount received is usually calculated as a function of an expense (state and/or local tax). This indicates an intent to reduce an operating expense, not to make a contribution to capital.

SETTLEMENT GUIDELINES

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

(a) [redacted]

(b) [redacted]

(c) [redacted]

(d) [redacted]

(e) [redacted]

(f) [redacted]

[redacted]

[redacted]

- [redacted]
- [redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

(a) [redacted]
(b) [redacted]
(c) [redacted]
(d) [redacted]
(e) [redacted]
(f) [redacted]

All lines marked with # are for Official Use Only

[redacted]

[redacted]

• [redacted]

• [redacted]

• [redacted]

[redacted]

[redacted]

[redacted]

[redacted]

All lines marked with # are for Official Use Only