

Office of Chief Counsel
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Memorandum

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to: Associate Area Counsel
(Small Business/Self-Employed)
CC:SB:4:MIL

from: Acting Chief, Branch 1
Office of Associate Chief Counsel
(Income Tax & Accounting)
CC:ITA:1

subject: Wisconsin Dairy Investment Tax Credit

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

ISSUE

What is the federal income tax treatment of the recently enacted dairy investment tax credit under §§ 71.07(3n) and 71.28(3n) of the Wisconsin Statutes?

CONCLUSION

The nonrefundable, nontransferable state tax credit is treated for federal income tax purposes as a reduction in state tax liability. To the extent a taxpayer deducts state taxes under I.R.C. § 164, the credit effectively reduces the § 164 deduction. The credit is not treated as a recovery or reimbursement of the capital expenditures for dairy farm modernization or expansion that qualify taxpayers for the credit.

FACTS

The following description reflects our understanding of the dairy investment credit based on our review of the relevant state statutes and the material on the website for the Wisconsin Department of Revenue.

Chapter 71 of the Wisconsin Statutes provides for income and franchise taxes for state and local revenues. Subchapter I, which contains §§ 71.01 through 71.10, provides for the taxation of individuals and fiduciaries. Subchapter IV, which contains §§ 71.22 through 71.30, provides for the taxation of corporations.

Sections 71.07(3n) and 71.28(3n) of the Wisconsin Statutes provide for a credit against the tax imposed under subchapters I and IV, respectively.¹ The credit is an amount equal to 10% of the amount the claimant paid in the tax year for dairy farm modernization or expansion related to the operation of the claimant's dairy farm. "Dairy farm modernization or expansion" means the construction, improvement, or acquisition of equipment for dairy animal housing, confinement, animal feeding, milk production, or waste management. The credit is not allowed for expenditures that are claimed as a deduction under I.R.C. § 162.

The credit is available for taxable years that begin after December 31, 2003, and before January 1, 2010. The maximum aggregate amount that may be claimed by a claimant during this six-year period is \$50,000. The credit is nonrefundable and may be carried forward for up to 15 years. See Wis. Stat. §§ 71.07(3n)(f), 71.28(3n)(f), and 71.28(4)(f). We understand that the credit is not transferable. Under state law, the amount of the credit must be included in the claimant's income except that credits computed by a partnership and passed through to partners are added to the partnership's income, and credits computed by a tax-option corporation and passed through to shareholders are added to the tax-option corporation's income. See Wis. Stat. §§ 71.05(6)(a)15, 71.21(4), 71.26(2)(a), and 71.34(1)(g); Wisconsin Tax Bulletin 138, p. 41 (April 2004).

LAW AND ANALYSIS

Section 61(a) of the Internal Revenue Code provides that, except as otherwise provided, gross income means all income from whatever source derived. Section 1.61-1(a) of the Income Tax Regulations provides that gross income includes income realized in any form, whether in money, property, or services.

Under the "tax benefit rule," partially codified in § 111 of the Code, a refund of state tax is generally excludable from federal gross income to the extent that the refund represents a recovery of an amount of state tax that was deducted without tax benefit in a prior year.

¹ We were not asked to address the tax credit that applies to insurance companies in § 71.47(3n) of the Wisconsin Statutes.

Section 164(a) of the Code generally allows as a deduction certain types of taxes, listed in § 164(a)(1)-(5), that are paid or accrued within the tax year. See also § 1.164-1(a) of the Income Tax Regulations. Specifically, § 164(a)(3) provides for the deduction of state and local income taxes paid or accrued within the tax year. Additionally, § 164(a) provides for the deduction of state and local taxes not described in § 164(a)(1)-(5) that are paid or accrued within the tax year in carrying on a trade or business or an activity described in § 212 (relating to expenses for production of income). See also Rev. Rul. 70-561, 1970-2 C.B. 40 (Pennsylvania excise tax imposed on corporate net income is deductible under § 164(a)).

Under § 1012 of the Code, the basis of property is generally its cost. Section 167 provides for a depreciation deduction for business property. Taxpayers may elect to expense the cost of certain depreciable business assets under § 179.

Generally, a state tax credit, to the extent that it can only be applied against the recipient's current or future state tax liability, is treated for federal income tax purposes as a reduction or potential reduction in the taxpayer's state tax liability. The amount of the credit is not included in the taxpayer's federal gross income, or otherwise treated as a payment from the state, and is not deductible as a payment of state tax under § 164. Cf. Rev. Rul. 79-315, 1979-2 C.B. 27, Holding (3) (1978 Iowa income tax rebate credited against 1978 tax due is neither includible in federal gross income nor deductible under I.R.C. § 164). Similarly, an accrual-basis taxpayer is not required to take the value of such future tax credits into income; the credits will simply reduce the taxpayer's otherwise-deductible tax liabilities as, and if, they accrue. See Snyder v. United States, 894 F.2d 1337, 1990 U.S. App. LEXIS 1603 (6th Cir. 1990).

In certain situations, in order to reflect the substance of a transaction and treat similarly-situated taxpayers fairly, a reduction in state tax liability may be recharacterized, for federal tax purposes, as a deemed payment by the state to the taxpayer. 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 recharacterization 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.

The Wisconsin dairy investment credit illustrates the normal case, in which a state tax credit is treated for federal tax purposes as a reduction in tax, not as an item of income and an offsetting payment of tax. See Holding (3) of Rev. Rul. 79-315. The dairy investment credit is not treated for federal tax purposes as a recovery or reimbursement of the capital expenditures for dairy farm modernization or expansion that qualify taxpayers for the credit. The treatment of the credit for state tax purposes—the fact that the amount of the credit is included in the claimant's gross income for state tax purposes—does not change its federal tax treatment.

More specifically, to the extent a taxpayer deducts state taxes under I.R.C. § 164, the Wisconsin dairy investment credit simply has the federal tax effect of reducing the § 164 deduction (in an amount that is partially offset by the increase in state tax caused by including the amount of the credit in state income). Similarly, the fact that a state tax refund is attributable, in whole or in part, to the reduction in state tax caused by the dairy investment credit does not affect the federal tax treatment of the refund as a refund of state tax; as such, the refund is generally includible in gross income unless, pursuant to § 111, the prior payment of state tax did not result in a tax benefit. Because the dairy investment credit is treated as a reduction in state tax liability, not a recovery or reimbursement of the expenditures that qualify a taxpayer for the credit, the credit does not affect the basis, for federal tax purposes, of the assets with respect to which those expenditures are made, and it is irrelevant whether the taxpayer took depreciation on those assets, or expensed their cost under § 179.

Please call (202) 622-4950 if you have any further questions.