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subject: New York QEZE Credit for Real Property Taxes

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

ISSUE

What is the proper federal income tax treatment of the State of New York Qualified Empire Zone Enterprise (QEZE) Credit for Real Property Taxes?

FACTS

The following summarizes the relevant general rules for the State of New York QEZE Credit for Real Property Taxes.¹

General Overview

¹ The facts are based primarily on the information contained in the following materials issued by the New York State Department of Taxation and Finance: TSB-M-06(1)C/TSB-M-06(2)I -- *Qualified Empire Zone Enterprise (QEZE) Tax Credits* (Feb. 2, 2006); 2007 Instructions for Form CT-606, *Claim for QEZE Credit for Real Property Taxes*; and 2007 Instructions for Form IT-606, *Claim for QEZE Credit for Real Property Taxes*. Citations to specific pages of those materials and quotation marks have been omitted to make the facts easier to read.

Among other benefits available to businesses that invest in certain designated areas of New York State, the state provides a corporate income tax (franchise tax) credit or a personal income tax credit for taxes paid on real property located in an Empire Zone, with respect to a business that qualifies as a QEZE.

To qualify as a QEZE, a business must be located within a designated zone and meet an annual test of maintaining or increasing the number of full-time employees.

The amount of the credit is based on one of two formulas, depending on the date the business first became a QEZE. One formula calculates a portion of real property taxes based on two factors that reflect (1) the increase in the number of employees and (2) the length of time since the business first became a QEZE (resulting in a decreased credit for the later years). The other formula takes into account either a percentage of the wages and benefits of new employees or a percentage of capital investment in Empire Zones.

Under either formula, the income tax credit cannot exceed the amount of real property taxes paid. The credit is available for up to 14 years, for the earlier version, or 10 years, for the current version, and is refundable for income tax purposes – that is, it can be obtained as a cash payment to the extent it exceeds the taxpayer's income tax liability for a year.

Qualification as a QEZE

The State of New York Empire Zones Program was enacted in 2000² and applies to tax years beginning on or after January 1, 2001. Among other benefits, the program provides for a Credit for Real Property Taxes against corporate or personal income tax³ for Qualified Empire Zone Enterprises (QEZE) that annually meet an employment test.⁴

A QEZE is a business enterprise that has been certified as eligible to receive benefits under Article 18-B of the state General Municipal Law⁵ and that annually meets an employment test during a business tax benefit period.⁶

² The state had an Economic Development Zone Program prior to this time.

³ The taxes against which the credit can be applied are those imposed under Articles 9-A (Franchise Tax on Business Corporations), 22 (Personal Income Tax), 32 (Franchise Tax on Banking Corporations), or 33 (Franchise Tax on Insurance Corporations) of the State of New York Tax Law.

⁴ QEZE's also can be eligible for a Tax Reduction Credit and a sales and use tax exemption. See TSB-M-05(16)S – *Qualified Empire Zone Enterprise (QEZE) Exemptions from Sales and Compensating Use Tax* (Dec. 28, 2005). For information about the various credits available to taxpayers within Empire Zones, see New York State Department of Taxation and Finance Publication 26, *A Guide to Business Tax and Personal Income Tax Credits Within Empire Zones* (Feb. 2001).

⁵ Section 956 of that article reads as follows:

The "employment test," in the case of a business first certified before April 1, 2005 (a pre-4/05 business), will be met for a tax year if (1) the business's employment number⁷ in all Empire Zones for the tax year equals or exceeds its employment number in all Empire Zones for the base period, and (2) the business's employment number in New York State outside of the Empire Zones for the tax year equals or exceeds its employment number in the state outside of the Empire Zones for the base period. In the case of a business first certified on or after April 1, 2005 (a post-4/05 business), the employment test will be met for a tax year if (1) the business's employment number in New York State for the tax year exceeds its employment number in the state for the base period, and (2) the business's employment number in all Empire Zones for the tax year exceeds its employment number in all Empire Zones for the base period. "Base period" generally means the five tax years immediately before the test year,⁸ for a pre-4/05 business, or the four tax years immediately before the tax year it was first certified, for a post-4/05 business.

The "business tax benefit period" is: (1) for businesses with a pre-2002 test date, the first 15 tax years beginning on or after January 1, 2001; (2) for businesses with a test date between January 1, 2002, and March 31, 2005, the first 15 tax years following the test year; or (3) for businesses certified after March 31, 2005, the first 10 tax years starting with the year of certification.

Calculation and Application of Credit

A taxpayer that is a QEZE, a sole proprietor of a QEZE, a shareholder of an S corporation that is a QEZE, or a partner in a partnership that is a QEZE, is allowed a credit against income (franchise) tax for eligible real property taxes.

It is hereby found and declared that there exist within the state certain areas characterized by persistent and pervasive poverty, high unemployment, limited new job creation, a dependence on public assistance income, dilapidated and abandoned industrial and commercial facilities, and shrinking tax bases. These severe conditions require state government to target for these areas extraordinary economic and human resource development programs in order to stimulate private investment, private business development and job creation. It is the public policy of the state to offer special incentives and assistance that will promote the development of new businesses, the expansion of existing businesses and the development of human resources within these economically impoverished areas and to do so without encouraging the relocation of business investment from other areas of the state. It is further found and declared that it is the public policy of the state to achieve these goals through the mutual cooperation of all levels of state and local government and the business community.

⁶ For tax years beginning on or after January 1, 2004, agricultural cooperatives are eligible for the credit. A QEZE also includes a certified clean energy enterprise that annually meets the employment test.

⁷ "Employment number" means the average number of individuals (excluding general executive officers, in the case of a corporation) employed full-time by the business for at least one-half of the tax year.

⁸ "Test year" means the last tax year of the business ending before the test date (the later of July 1, 2000, or the date the business was first certified as a QEZE).

“Eligible real property taxes” mean the taxes imposed on real property owned by the QEZE and located in an Empire Zone in which the QEZE is certified. The real property taxes must have been paid by the QEZE that is the owner or by a tenant (provided the tenant is not itself a QEZE or cannot treat the payment as eligible real property taxes).⁹ The taxes must become a lien on the real property in a tax year in which the owner is both certified and a QEZE. In general, the lien date is the first day of the period for which the taxes are imposed. Payments in lieu of taxes (PILOTs) are considered eligible real property taxes if certain conditions are met.

For a pre-4/05 QEZE, the amount of the credit is equal to the eligible real property taxes (or pro rata share in the case of a partner or S corporation shareholder) multiplied by the following two factors: 1) the benefit period factor; and 2) the employment increase factor.¹⁰ The “benefit period factor” gradually decreases from 1 to .2 over the 14-year benefit period. The “employment increase factor” (which cannot exceed one), is the greater of:

- 1) the increase in the QEZE’s employment number¹¹ in Empire Zones in which the QEZE is certified over the QEZE’s test-year employment number in those zones, divided by the QEZE’s test-year employment number; or
- 2) the increase in the QEZE’s employment number in zones in which the QEZE is certified, over the QEZE’s test-year employment number in those zones, divided by 100.

For a post-4/05 QEZE, the amount of the credit is the greater of 1) the credit amount; or 2) the capital investment amount. The “credit amount” is generally 25% of the total wages, health, and retirement benefits of net new employees for the tax year. The “capital investment amount” is generally 10% of the federal tax basis of real property owned by the QEZE and located in Empire Zones (as of a certain date), multiplied by the greater of: 1) the percentage physically occupied and used by the QEZE or a related person; or 2) the percentage of basis attributable to construction, expansion, or rehabilitation (as opposed to acquisition).

For both pre-4/05 and post-4/05 QEZEs, the amount of the credit cannot exceed the amount of eligible real property taxes.

For corporations and other entities, the amount of the credit used to reduce income or franchise tax for a given year cannot reduce the tax below certain minimum amounts,

⁹ For tax years beginning on or after January 1, 2005, “eligible real property taxes” also include taxes paid by a QEZE that is a lessee when certain conditions are met.

¹⁰ Certain additional limitations apply to QEZEs certified between July 31, 2002, and March 31, 2005.

¹¹ See fn. 7 above.

calculated differently for agricultural cooperatives, business corporations, banking corporations, and insurance corporations. For taxpayers subject to personal income tax, the credit can reduce the tax to zero.

Any amount of the credit not used in the current tax year – including any portion precluded by the minimums described in the preceding paragraph – may be refunded or applied as an overpayment against the tax liability for the next tax year. However, no interest is paid on such a refund or credit.

A portion of the QEZE real property tax credit must be recaptured if the amount of the real property taxes on which the credit was calculated is subsequently reduced by a final order in any legal proceeding, to the extent the recalculated credit exceeds the credit originally taken. For post-4/05 QEZEs, recapture is only necessary if the real property taxes are reduced to an amount less than the original credit taken.

Eligible S corporations and partnerships compute the credit and provide their shareholders or partners with their pro rata share of the credit (or recapture). Individual shareholders or partners claim their share of the credit on New York Form IT-606.

LAW AND ANALYSIS

Section 164(a) of the Internal Revenue Code provides for the deduction of the following taxes paid or accrued within the tax year: (1) state and local real property taxes, (2) state and local personal property taxes, and (3) state and local income taxes.

Section 461(a) provides the general rule that the amount of any deduction or credit allowed by subtitle A shall be taken for the tax year that is the proper tax year under the method of accounting used in computing taxable income.

Section 1.461-1(a)(1) of the Income Tax Regulations provides that, under the cash receipts and disbursements method of accounting, amounts representing allowable deductions shall generally be taken into account for the tax year in which paid. See also § 1.446-1(c)(1)(i).

Sections 1.446-1(c)(1)(ii)(A) and 1.461-1(a)(2)(i) provide that, under an accrual method of accounting, a liability is incurred (and generally is taken into account) in the tax year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred for the liability. Section 1.461-4(g)(6) provides that, if the liability of a taxpayer is to pay a tax, economic performance occurs as the tax is paid to the governmental authority that imposed the tax. In certain cases, a liability to pay a tax is permitted to be taken into account in the tax year before the tax year during which economic performance occurs under the recurring item exception of § 1.461-5.

Section 61(a) of the Code provides that, except as otherwise provided, gross income means all income from whatever source derived. See also Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 431, reh'g denied, 349 U.S. 925 (1955) (holding gross income encompasses any item representing "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion").

Section 111(a) provides that gross income does not include income attributable to the recovery during the tax year of any amount deducted in any prior tax year, to the extent that amount did not reduce the amount of tax imposed by chapter 1 of the Code.

Generally, the tax benefit rule requires a taxpayer who received a tax benefit from a deduction in an earlier year to recognize income in a later year if there occurs an event that is fundamentally inconsistent with the premise on which the deduction was initially based. Hillsboro National Bank v. Commissioner, 460 U.S. 370, 383 (1983). The term "tax benefit rule" encompasses two concepts, an inclusionary part and an exclusionary part. The inclusionary part has been developed in the courts and requires a taxpayer to include a previously deducted amount in the current year's income when a fundamentally inconsistent event has occurred. The exclusionary part is currently codified at § 111 and permits a taxpayer to exclude an amount that did not previously provide a tax benefit when it was deducted.

The tax benefit rule allays some of the inflexibilities of the annual accounting system under specific circumstances. Hillsboro, 460 U.S. at 377. Its purpose is to approximate the results produced by a tax system based on transactional rather than annual accounting. Id. at 381. The tax benefit rule will "cancel out" an earlier deduction when the later event is fundamentally inconsistent with the premise on which the deduction was initially based, even if there is no actual recovery of funds. Id. at 381-383.¹² One must consider the facts and circumstances of each case in light of the purpose and function of the provision granting the deduction. Id. at 385. Although it is usually helpful to determine whether the later event would have foreclosed the deduction if it had occurred within the same tax year, that inquiry is not an exclusive test. See American Mutual Life Insurance Co. v. United States, 267 F.3d 1344, 1350 (Fed. Cir. 2001).

Your request for assistance indicated that it was not related to any particular case. Rather, it was for the purpose of obtaining general information concerning the basic federal tax treatment of the QEZE Real Property Tax Credit. Accordingly, for the purposes of the following analysis, we assume that the QEZE is the owner of the real property, it pays the real property taxes, these property taxes are not required to be capitalized for federal income tax purposes, and would generally be deductible under § 164 of the Internal Revenue Code.

¹² Under Hillsboro, this principle is subject to possible modification if the recovery or inconsistent event occurs in the context of a nonrecognition or other provision, the purpose of which might need to be considered. See id. at 385-86, n. 20. There is no such provision in the present situation.

The first, and simplest, situation to consider is a C corporation that uses the cash receipts and disbursements method of accounting.¹³ Such a taxpayer would deduct state and local real property taxes for the tax year during which the taxes are paid (Year 1). The federal income tax return and the state franchise tax return for that year would be filed in the following year (Year 2). On the state return, the taxpayer would claim the QEZE real property tax credit with respect to taxes paid in Year 1. The credit could either reduce the amount of state franchise tax imposed for Year 1 and/or result in a payment from the state in Year 2. Consequently, it is necessary to determine whether the state franchise tax reduction and/or a payment attributable to a refundable credit is fundamentally inconsistent with the § 164 deduction for property taxes.

Before analyzing the credit under the inclusionary part of the tax benefit rule, it would be helpful to review the general treatment of state income tax credits. Although any reduction in liability can potentially be recharacterized as a means of making a payment to the obligor, the traditional federal tax treatment of nonrefundable, nontransferable state income tax credits, with some exceptions, has been as a reduction in liability. Cf. Rev. Rul. 79-315, 1979-2 C.B. 27, Holding (3). Under certain circumstances, it may be appropriate to recharacterize a state or local tax benefit as something other than a reduction in liability that decreases a § 164 deduction. Cf. Watervliet Paper Co. v. Commissioner, 16 B.T.A. 604 (1929) (local tax reduction could be viewed as payment for services). This could occur when the state or local tax benefit is provided for specific consideration, such as specific services, property, or the use of property, and the taxpayer could be viewed as having satisfied its tax liability in kind. This is not the case here, however.

With respect to refundable state tax credits, the Service and the Treasury Department have not issued published guidance addressing the treatment of such credits. However, some informal nonprecedential advisories have applied an approach whereby a refundable credit is "bifurcated." That is, refundability, by itself, 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 tax before the tax becomes due is still generally treated as a reduction in tax; only to the extent the credit exceeds the tax liability and is made available to the taxpayer as a cash payment is it treated as a payment from the state, includable in income unless some exclusion applies.

After considering the facts and circumstances of the QEZE real property tax credit, the traditional treatment of state income tax credits as reductions in liability, and the purpose and function of § 164, we conclude that the state franchise tax reduction attributable to the credit is not fundamentally inconsistent, for purposes of applying the tax benefit rule, with a previous § 164 deduction for property taxes taken by a C corporation that uses the cash receipts and disbursements method of accounting. The

¹³ See § 448(b) for the exceptions from the general rule that a C corporation cannot use the cash receipts and disbursements method of accounting.

federal income tax consequence is therefore a reduction in state franchise tax, generally deductible under § 164.

We further conclude, however, that receipt of a cash payment attributable to the refundable credit is fundamentally inconsistent with a previous § 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 the provisions of § 111. Cf. Rev. Rul. 70-86, 1970-1 C.B. 23. The refunded amount would be treated as a recovery of property tax, not franchise tax, and would be includable in federal gross income in Year 2 depending on the extent to which deduction of the Year 1 payment of state property tax reduced the taxpayer's Year 1 federal income tax.

Since the taxpayer has the option of receiving such an excess, "refunded" amount of the credit in cash, the taxpayer would be in constructive receipt of that amount even if the taxpayer chose to use it as a credit against state tax for another tax year. Cf. Schulz v. United States, Civil No. 76-C-646 (E.D. Wis. 1979), aff'd without published opinion, 624 F.2d 1103 (7th Cir. 1979), cert. denied, 445 U.S. 962 (1980). However, the taxpayer would also be treated as having made a corresponding payment of state tax for that other tax year.¹⁴

The preceding conclusions also apply to a sole proprietor who uses the cash receipts and disbursements method of accounting¹⁵ and -- in general -- to a C corporation or a sole proprietor using an accrual method of accounting. However, in the case of an accrual-basis taxpayer, and depending on the facts, there may be questions concerning how to treat the refunded portion of the credit, in terms of the timing of tax benefit income, and whether to accrue income or, alternatively, reduce the original deduction for real property taxes by the anticipated recovery. In light of an open revenue ruling project (2008-2009 Priority Guidance Plan, General Tax Issues #25) on this general issue, and the possible variations in different fact situations, we believe it is better to address these issues in the context of a particular case where the facts have been developed.

In order to furnish a timely response to the central questions, we have not discussed in detail other potential situations, such as the treatment of partners and S corporation shareholders, other than to state that the general principles discussed above would

¹⁴ A payment of estimated income tax pursuant to state law constitutes the payment of a tax within the meaning of § 164(a)(3) when the amount is based on a reasonable, good faith estimate of the taxpayer's actual tax liability. See Rev. Rul. 71-190, 1971-1 C.B. 70; Rev. Rul. 82-208, 1982-2 C.B. 58.

¹⁵ We believe that the state income tax reduction attributable to the credit is not fundamentally inconsistent with a previous § 164 deduction for property taxes even though the deduction under § 164(a)(1) – taken on a Form 1040, Schedule C (*Profit or Loss From Business*) – and the deduction under § 164(a)(3) – taken on Schedule A (*Itemized Deductions*) – are treated differently for purposes of the alternative minimum tax.

apply. We would be happy to provide further responses if, after consideration, you feel that addressing these or other situations in detail would be helpful.

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