Avoiding Pitfalls with Credits and Incentives

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Avoiding Pitfalls with Credits and Incentives Agenda

- Types of credits and incentives
- Federal income tax treatment
  - Section 118
    - Background
    - Current developments
  - Impact on other federal income tax benefits
Types of Credits and Incentives

- Income tax
- Property tax
- Sales/use tax

- Tax rate reductions
- Tax abatements
- Tax credits
  - Refundable
  - Transferable
- Tax exemptions
- Tax rebates

- Grants
- Loans
Credits and Incentives
Federal Income Tax Treatment

- Taxable – included immediately in gross income
- Taxable – reduction of otherwise currently deductible item
- Deferred – excludable, reduction in tax basis
- Permanent benefit
Sections 61 and 118  
Summary of Statutes

• Section 61(a) – gross income means all income from whatever source derived, unless excluded by law
• Section 118(a) – exclusion from gross income for any contribution to the capital of a corporate taxpayer
• Section 118(b) – exception from the term “contribution to the capital of the taxpayer” for any contribution in aid of construction from a customer or potential customer
• Section 118(c) – the term “contribution to the capital of the taxpayer” includes contributions in aid of construction received by water and sewer utilities
Contributions to the Capital of a Corporation – Reg. Sec. 1.118-1

- Shareholder contributions, including if there is no additional issuance of stock
- Non-shareholder contributions
  - 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.
Public Benefit Exception

• The House Ways and Means Committee Report for the Tax Reform Act of 1986 explains that
  – Where all members of a particular group make transfers of property to the utility, normally it will be assumed that such transfers are to encourage the provision of services,
  – *Unless it is clearly shown that the benefit of the public as a whole was the primary motivating factor in the transfers.*
Basis of Property Received
Section 362(c)

362(c)(1) PROPERTY OTHER THAN MONEY. -- Notwithstanding subsection (a)(2), if property other than money --

is received by a corporation, on or after June 22, 1954, as a contribution to capital, and

is not contributed by a shareholder as such,

then the basis of such property shall be zero.

362(c)(2) MONEY. -- Notwithstanding subsection (a)(2), if money --

is received by a corporation, on or after June 22, 1954, as a contribution to capital, and

is not contributed by a shareholder as such,

then the basis of any property acquired with such money during the 12-month period beginning on the day the contribution is received shall be reduced by the amount of such contribution. The excess (if any) of the amount of such contribution over the amount of the reduction under the preceding sentence shall be applied to the reduction (as of the last day of the period specified in the preceding sentence) of the basis of any other property held by the taxpayer. The particular properties to which the reductions required by this paragraph shall be allocated shall be determined under regulations prescribed by the Secretary.
Electric Generation –
Transmission Interconnections

• Notices 88-129, 90-60 and 2001-82
• Requirements to be excludable under Section 118(b)
  – Includable to the extent the intertie is included in the Utility's rate base
  – Term of the power purchase contract or interconnection agreement may not be less than 10 years
  – Ownership of the electricity wheeled must pass to the purchaser prior to its transmission on the Utility's transmission grid. Deemed satisfied if title to electricity wheeled passes to the purchaser at the busbar on the Generator's end of the intertie.
  – No more than 5 percent of the projected total power flows over the intertie will flow to the Generator (the "5 percent test")
The primary relationship between the Generator and the Utility arises from the sale of electricity by the Generator (supplier) to the Utility (customer). The provision of transmission services by the Utility to the Generator is disregarded in determining whether the reimbursement is taxable.

Purpose of reimbursement by the Generator is to permit the sale of power by the Generator to the Utility, its affiliates, intermediaries or third parties.
Standardization of Generator Interconnection Agreements and Procedures (FERC Order No. 2003)

- **Indemnification**
  - Interconnection customers shall indemnify transmission provider from income taxes imposed as a result of payments or property transfers
  - No gross-up unless:
    - Provider has determined, in good faith, the payments should be reported as income
    - Any governmental authority directs provider to report as income
      - Transmission provider must notify interconnection customer within 30 days of receiving notice
  - Reasonable security to interconnection customer making indemnification payment
  - Indemnification obligation terminates at the earlier of:
    - Expiration of 10-year testing period (Notice 88-129) and the applicable statute of limitations
    - Occurrence of a subsequent taxable event and the payment of any related indemnification obligation
Tax gross-up:

\[
\frac{\text{Current tax rate} \times (\text{gross income} - \text{PV}\text{ of tax depreciation})}{1 - \text{current tax rate}}
\]

*Transmission provider’s composite federal and state tax rates at the time payments/property transfers are received and subject to highest marginal rates at that time

**Transmission provider’s current weighted cost of capital
Standard Interconnection Agreement Refunds

• A transmission provider shall effect a refund to the interconnection customer if:
  – A PLR holds that the transfer is not subject to federal income tax
  – Any notice, ruling, etc., makes it reasonably clear in good faith that the transfer is not taxable
  – An abatement, appeal, protest or other contest results in a determination that the transfer is not taxable
  – If transmission provider receives a refund attributable to the transfer

• The refund will consist of:
  – Any payments, with interest, made by interconnection customer for taxes that are attributable to nontaxable amount
  – Any tax payments made by interconnection customer to transmission provider not submitted to taxing authority
  – Any refund, with interest, received by transmission provider after provider has received a refund related to its interconnection facility
Chicago, Burlington & Quincy Railroad Co.
Five-factor Test

1) Must become a permanent part of the transferee’s working capital structure
2) May not be compensation, such as a direct payment for a specific quantifiable service provided by the transferee
3) Must be bargained for
4) Must benefit the transferee commensurate with its value
5) Must ordinarily be employed in, or contribute to, the production of additional income and its value assured in that respect
Incentives and Reimbursements Received by Partnerships/LLCs

- Tier I issue – three Section 118 abuse directives
  - Section 118 is only applicable to corporations.
  - No independent common law “contribution to capital” doctrine exists.
  - Misapplications – USF payments, subsidies, grants, incentives from governments, the public, civic groups, etc.
  - Generic information document request

CONTRIBUTIONS TO THE CAPITAL OF A CORPORATION

118(a) GENERAL RULE. -- In the case of a corporation, gross income does not include any contribution to the capital of the taxpayer.
IRS Coordinated Issue Paper
State and Local Location Tax Incentives

• Issued May 23, 2008
• Location tax incentives
  – Covers: abatement credit, deduction, rate reduction or exemption
  – Out of scope: refundable or transferable credits
• Alternative positions
  – State/local tax reductions decrease the federal deduction
  – State/local tax reduction is an incentive payment and the full amount of state tax is deductible
State and Local Location Tax Incentives
IRS Coordinated Issue Paper – IRS View

• Location tax incentives, regardless of the form they take, are not an item of gross income.
  – As such, a location tax incentive does not qualify for exclusion under Section 118(a).
• Location tax incentives, regardless of the form they take, are not deductible as tax paid/accrued.
• Even if a location tax incentive were treated as an item of gross income, it would generally not be excludable as a non-shareholder contribution to capital.
Federal Income Tax Deductibility of Taxes

• Section 164 - the following taxes shall be allowed as a deduction for the taxable year within which paid or accrued:
  – State and local, and foreign, real property taxes
  – State and local personal property taxes
  – State and local, and foreign, income taxes
  – State and local, and foreign, taxes not described in the preceding sentence.

• Section 461 - 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
  – Eligible for the recurring item exception
FAA Airport Improvement Grant
Rev. Rul. 93-16

- Project grant made by the Federal Aviation Administration (FAA) to a corporate owner of a public-use airport under the Airport Improvement Program (AIP)
  - To improve public safety and efficiency at public-use airports
  - Airport planning and airport development, including construction, hazard removal, acquisition or installation of air navigation aids and safety or security equipment, and land acquisition.

- Holdings –
  - Nonshareholder contribution to the capital of the corporation under Section 118(a)
  - Basis in the corporation's property is reduced under Section 362(c)(2)
Universal Service Funds
Rev. Rul. 2007-31

• Federal and state universal service support mechanisms
  – Programs administered by the Federal Communication Commission or states to support the high cost of providing various services to low income consumers and those in rural, insular, and high cost areas
  – Goal – provide the widespread availability of basic telecomm services at rates that are reasonably comparable to rates charged for similar services in urban areas
  – Funded by contributions from telecomm carriers
  – Administered by the Universal Service Administrative Company
  – Distributions to telecomm carriers

• Universal service support payments received do not represent non-shareholder contributions to capital under Section 118(a)

• *U.S. v. Coastal Utilities, Inc.*, (CA-11, 2008) and other pending litigation
Regulated public utility operating sanitary sewer lines and sewerage disposal plants charges a "customer connection fee" to certain customers when building lines to extend its existing infrastructure to the customer in order to start sewerage disposal services.

Utility’s lifetime taxable income with respect to its customer connection fees is the same whether those fees are treated as
- Gross income followed by allowable depreciation deductions or
- Nontaxable CIACs resulting in zero basis and no depreciation deductions
Change in Accounting Method
Rev. Rul. 2008-30 – Holding

• A change from treating certain payments received from customers as nontaxable contributions to capital under Section 118(c) to treating the payments as taxable customer connection fees is a change in method of accounting under Sections 446 and 481.

• Similarly, a change from treating customer connection fees as taxable customer connection fees to nontaxable contributions to capital under Section 118(c) constitutes a change in method of accounting under Sections 446 and 481.

• The Service does not acquiesce in the holdings on this issue in Saline Sewer Co. v. Commissioner and Florida Progress Corp. v. United States.
Favorable Financing
Impact on Section 48 Energy Tax Credit

• Investment tax credit
  – 30 percent: solar energy property, qualified fuel cell property
  – 10 percent: stationary microturbine property
• Limitation on energy property financed in whole or in part by the proceeds of tax-exempt private activity bonds or subsidized energy financing
  – Proportionate reduction in basis
  – Section 48(a)(4)
• Public utility property is not eligible for Section 48 credit.
Normalization of Other Credits
Section 50(d)

• CERTAIN RULES MADE APPLICABLE. -- For purposes of this subpart, rules similar to the rules of the following provisions (as in effect on the day before the date of the enactment of the Revenue Reconciliation Act of 1990) shall apply: . . .
  – Section 46(f) (relating to limitation in case of certain regulated companies).

• Other applicable credits*
  – Rehabilitation credit - Section 47
  – Qualifying advanced coal project credit - Section 48A
  – Qualifying gasification project credit - Section 48B

*Public utility property does not qualify for the Section 48 energy credit.
Favorable Financing
Impact on Section 45 Production Tax Credit

• Proportionate reduction in the amount of the credit based on the portion of the plant basis financed with specified governmental assistance
• Maximum reduction = 50 percent
• Section 45(b)(3)
Specified Governmental Assistance Impact on Section 45 Production Tax Credit

- Grants by the U.S., a state or political subdivision of a state for use in connection with a project
- Proceeds from tax-exempt state or local obligations used to provide project financing
- Subsidized energy financing provided (directly or indirectly) under a federal, state or local program
- The amount of any other credit allowable with respect to any property which is part of the project
  - Rev. Rul. 2006-9 – Limitation does not apply to state or local credits
Avoiding Pitfalls with Credits and Incentives Conclusions

• Consider the income tax costs in assessing the after-tax benefit of credit and incentive alternatives
  – Inside v. outside the tax system
  – Basis reduction rules
  – Timing of recognition of taxable benefits

• Consider the impact on other potential tax benefits