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Court Clarifies Taxability Of Excess Refundable Credits

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The United States Tax Court has released an opinion regarding a dispute between taxpayers and the IRS regarding whether non-need-based, excess refundable state tax credits are taxable income under federal law.[1] The Tax Court sided with the IRS in finding that such excess credits are taxable.[2] Moreover, such excess credits are taxable in the year they are earned, even if the taxpayer would be willing to carry them forward to offset future taxable income.[3] This was a case of first impression, neither side disputed the facts.[4]

Section 61:[5] Defining Gross Income

The Tax Court quickly turned to Section 61 to resolve this dispute.[6] Section 61 defines "gross income" as including "all income from whatever source derived."[7] The Tax Court then quoted Commissioner v. Glenshaw Class Co. to add to this definition of "gross income" by noting that payments that are "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion" constitute taxable income unless an exception applies.[8]

The Tax Court conceded that tax credits that merely reduce taxes owed do not constitute gross income.[9] The dispute in this case was solely about the excess refundable credits available to a taxpayer once the taxpayer has already zeroed out his or her taxable income in a given year. Here, the taxpayers paid no state income taxes in 2005, 2006 or 2007 and had access to large refund payments in each of those years.

Section 61: Exceptions

The taxpayers set forth various arguments to thwart the expansive scope of Section 61.

The taxpayers argued that the refunds were simply returned funds for overpayments of taxes, because that is how New York state labeled the payments in question (as "credits" for "overpayments" of state income tax).[10] The Tax Court disagreed with New York state's labels (noting that the taxpayers had paid no state income tax in the years in question) and quickly dismissed this argument by citing the substance-over-form doctrine and stating that federal law would not be dependent on state-given

labels.[11] To articulate this issue of semantics, the Tax Court cited an Abraham Lincoln adage: “Calling the tail [of a dog] a leg would not make it a leg.”[12] The Tax Court viewed the excess refundable credits as “subsidies” and not as a return of capital.[13]

Another argument set forth by the taxpayers was that their receipt of the credits fell within the general welfare exception to Section 61.[14] The general welfare exception allows certain payments from social benefit programs to not be included in gross income.[15] The general welfare exception applies only with respect to “need-based” government programs.[16] Here, the Tax Court determined that the tax credits in question (economic development zone credits for businesses) were not need-based, and thus the general welfare exception could not be applied.[17]

The Tax Court noted that the excess refundable tax credits would have been deemed “constructively received” by the taxpayers regardless of whether the taxpayers claimed the credits in the year they were earned or carried them forward to be applied against future tax liabilities.[18] In reaching this conclusion, the Tax Court relied on the Section 451 concept that a taxpayer must recognize income when the taxpayer has an unqualified right to receive immediate payment.[19]

Key Takeaway

With respect to refundable state tax credits that are not need-based, taxpayers may exclude the value of such credits for federal income tax purposes only to the extent they offset current year taxable gain. Any value of the credits earned in excess of this should be included as gross income in the current year. Unless this case is overturned in subsequent litigation, tax advisers, when considering the economics of transactions that involve refundable state tax credits, should be sure to account for the federal income tax cost of such refundable tax credits.

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[1] Maines v. Comm’r, 144 T.C. No. 8 (Mar. 11, 2015). The three credits at issue in this case were the New York state: (1) Empire Zone Investment Credit (the “EZ Investment Credit”); (2) Empire Zone Wage Credit (the “EZ Wage Credit”); and (3) Qualified Empire Zone Enterprise Credit for Real Property Taxes (“QEZE Credit for Real Property Taxes”).

[2] Id. at 80.

[3] Id. at 78.

[4] Id. at 74 (“It is a novel and purely legal question.”).

[5] All “section” references are to the Internal Revenue Code of 1986, as amended, unless otherwise indicated.

[6] Id. at 77.

[7] IRC § 61.

[8] Maines v. Comm'r, 144 T.C. No. 8, 77 (quoting Comm'r v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955)).

[9] Id. at 78.

[10] Id. at 76.

[11] Id. at 77.

[12] Id. at 76 (quoting George W. Julian, Lincoln and the Proclamation of Emancipation, in Reminiscences of Abraham Lincoln By Distinguished Men of His Time 227, 242 (Allen Thorndike Rise ed., Harper & Bros. Publishers 1909) (1885)).

[13] Id. at 77.

[14] Id. at 79.

[15] Id. at 79 (citing Rev. Rul. 2005-46, 2005-2 C.B. 120).

[16] See id. at 80 (citing Baily v. Comm'r, 88 T.C. 1293, 1300 (1987)).

[17] Id. at 80 (noting that critics might call economic-development-zone credits "corporate welfare").

[18] Id. at 78.

[19] Id. at 79 (citing Treas. Reg. § 1.451-2 and Martin v. Comm'r, 96 T.C. 814, 823 (1991)).

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