The Transferability and Monetization of State Tax Credits

The transferability of state tax credits enables a company or corporation with a low tax burden to utilize part of the credit and to sell the remainder of the credit to a company facing a larger tax liability.

Author: JENNIFER A. ZIMMERMAN

JENNIFER A. ZIMMERMAN is a lawyer with Horwood Marcus & Berk Chartered in Chicago, Illinois, and concentrates her practice in state and local tax planning and the resolution of state and local tax controversies for multi-state and multi-national corporations. She thanks Megan E. Toal, a law clerk in her third year at Loyola University Chicago School of Law, for her assistance with this article.

The transferability and monetization of state tax credits is a relatively new concept. State tax credits evolved from two federal tax credit programs created in the 1980s. States utilize tax credits in order to promote or encourage investments in economic development and increasingly to prevent existing jobs and businesses from moving out-of-state. Tax credits offer a "dollar-for-dollar reduction" of a taxpayer's tax liability. ¹

The problem encountered early on in the promotion of these credits was what to do if the credit cannot be fully utilized by the taxpayer. Sale, or transferability, of tax credits was one possible solution. While on the federal level there is a large pool of potential tax credit buyers, this is not necessarily true on the state level.

Currently, 46 states offer some form of tax credit granted through statute and implemented through various programs. ² Because of the recent expansion of state tax credit systems, exchanges are emerging to help taxpayers and businesses utilize state tax credits to their advantage. ³ The transferability of state
tax credits enables a company or corporation with a low tax burden to utilize part of the credit and to sell the remainder of the credit to a company facing a larger tax liability.

Transferability keeps tax credit programs attractive to businesses regardless of tax liability while preventing the credit from going to waste. However, it must be noted that there has been some controversy among states as to whether the transferability of the tax credits achieves the ultimate goal of the states that have issued the credits.

Background

Some brief background on the history of tax credits follows.

1960s and 1970s. Tax credits to encourage capital investment have been in existence since the 1960s. Under the initial [federal] investment tax credit, a taxpayer could reduce its federal income tax obligation by seven percent of the amount that it invested in "qualifying property." Originally, taxpayers would need to reduce their basis in the property in which the credit is linked; however, that requirement was removed two years after the statute’s enactment because it greatly diminished the incentive for taxpayers to utilize this type of credit.

For the next 10 to 15 years there were many changes made to federal tax incentives as Congress attempted to manage and expand economic investment through the use of this mechanism. However, during the 1960s and through the 1970s these credits could not be transferred or refunded. As a result, taxpayer use was greatly restricted.

In an attempt by Congress to expand the use of tax credits, the Revenue Act of 1978 (the “1978 Act”) expanded the applicability of federal incentive tax credits. The 1978 Act provided an investment credit for the rehabilitation of older properties and certified historic structures. The Ways and Means Committee of the U.S. House of Representatives explained in a report that: "The committee believes that it is appropriate now to extend the initial policy objective of the investment credit to enable business to rehabilitate and modernize existing structures. This change in the investment credit should promote greater stability in the economic vitality of areas that have been developing into decaying areas."

1980s and beyond. State tax credits evolved directly from two federal programs created in the 1980s. First, in 1986, the federal government created an incentive for developers to create low-income housing projects. The Federal Low Income Housing Program awarded developers tax credits, which would then
reduce their tax liability. The Low Income Housing Tax Credit provides a credit of 70 percent of the eligible basis in the new buildings, and a credit of 30 percent of the basis in buildings needing rehabilitation or repair. 11

Developers sold these credits to investors so that they could raise capital or equity for their projects. The credits enable the developers to undertake less debt and, therefore, allow the owners of the newly built property to charge lower rents to the occupants. The credit is provided to the developer for 10 years, typically beginning when the tenants move in. 12

This practice is important because it demonstrates the need for transferability; developers typically need the capital at the beginning of a project in order to finance it through completion. Therefore, it is important for the developer to have the ability and flexibility to sell his or her credit to an investor. Moreover, the developers and investors are not required to reduce their tax basis in the property to account for the benefit received by the tax credit. 13 Furthermore, taxpayers can still claim depreciation deductions for the properties. 14

The second federal tax credit that led to the evolution of state tax credits came in the form of the Federal Historic Preservation Tax Incentive program. The program seeks to restore, rehabilitate and re-use historic buildings by incentivizing the private sector to invest in these projects. 15

These credits are not bought and sold on the open market, but rather are transferred from developers to investors through a syndication process. This process usually involves the creation of a limited partnership between the two parties. With this limited partnership arrangement, the developer serves as the general partner and receives the majority of the cash flow, while the investor receives 99 percent of the profits, losses, depreciation and credits.

Many states have attempted to utilize credits in a way similar to the federal programs, in order to incentivize certain activities. State tax credit programs are often used to induce business entities to increase their capital expenditures and hire additional workers. However, in some instances, the taxpayer is unable to take advantage of the credit. Many posit that "state credits only work to create jobs and build new industries if companies can reap the benefits. This means that companies that earn credits but do not owe any state taxes need a place to sell them." 16

Consequently, states have provided mechanisms so that the credits do not go to waste. One common example of preventing waste and maintaining the attractiveness of the state credit program is through
transferability. These transferrable credits do not require any sort of partnership or legal relationship to exist between buyer and seller.

Varying Aspects of State Tax Credit Programs

The credits available to taxpayers of each state vary greatly. State legislatures are responsible for determining the amount of credits available. Because of this, the amount and manner of tax incentives vary dramatically throughout the United States.

Some scholars note that states in the Midwest and Southeast are quite competitive with one another for attracting new businesses to the respective states, while Western states incentivize businesses by offering lower tax rates and, therefore, the use of state tax credits as incentives is less prominent.

States may choose to place caps on the tax credits they issue. The caps may come in the form of an annual aggregate cap or an individual aggregate cap. States may also impose a statutory limit on the amount of credits that may be awarded annually.

In the event the demand for the tax credits exceeds the statutory limitation imposed by the state, applicants must compete for the amount. In some circumstances, states utilize a lottery system in granting the limited amount of available credits.

An annual cap on state tax credits may actually discourage or impede participation in the program, because an applicant may not want to prepare an intimidating application if there is little likelihood of being selected as a recipient of the credit. Furthermore, states may choose to cap the amount of tax credits available for an individual project.

Moreover, there is also much deviation among states on the implementation of state tax credits. For example, some states offer only non-transferable tax credits, while others offer transferable tax credits and/or refundable tax credits. Transferability can be offered through different means, namely: outright sale, offering refunds, allowing for carry-back, or disproportionate allocation.

While the first three methods are easily understandable, disproportionate allocation is a more difficult concept to grasp. Disproportionate allocation is a mechanism utilized by pass-through entities where a state tax credit is allocated to a taxpayer residing in the state where the project is located, while the federal tax credit for the exact same project is allocated to a person or entity residing out-of-state.
States that offer refundable tax credits simply refund the unused credit to the taxpayer. The taxpayer claims a refund in the amount that exceeds the taxpayer's tax liability in the state where the credit was issued. In some circumstances, a taxpayer may receive a refund even if he or she did not incur any income tax liability.  

However, recently an increasing number of states have authorized the transferability of state tax credits as opposed to simply refunding the unused amount. This means that a taxpayer may sell a portion of the credit, or the credit in its entirety if it cannot be used, to a different taxpayer with a current tax liability.

Common Activities Incentivized by State Tax Credits That Are Transferable

A review of state tax credits offered in many states follows.

**Film production.** Many states offer film production tax credits in order to lure film production companies and film productions to the offering state. However, because, in a majority of circumstances, tax owed to the state is minimal, many states allow excess unused credits to be transferred to another taxpayer who has a greater burden. These credits can be used against income tax, sales tax or a combination of the two.

These types of credits typically range from four to 25 percent of the "qualified production costs." State statutes vary on what constitutes a "qualified production cost."

For example, in 2009, former California Governor Arnold Schwarzenegger signed legislation into law that would create film production credits. This was included in a stimulus provision designed to improve the economic condition of the state. Under this bill, taxpayers would receive a credit for either 20 or 25 percent for qualified motion pictures.

Although many states allow these types of credits to be freely transferred, this particular legislation limits the transfers to one party. Moreover, once the credit has been claimed on a tax return, it is ineligible to be sold. California law mandates that if the original recipient of the tax credit claimed the credit on its refund and subsequently sold the credit to a third party who also claimed the credit, the Franchise Tax Board is empowered to disqualify the credit to either taxpayer.
On September 18, 2014, Governor Jerry Brown signed an additional bill to expand this program to allow more taxpayers to be involved. Funding for the newly expanded program is capped at $230 million for the fiscal year 2015-2016. The new legislation removes the current lottery system for selecting projects and instead involves a formulaic approach taking into account factors such as number of jobs created.

While California often comes to mind as a prime location for filmmaking, other states such as New York and New Mexico have received many economic benefits from film production occurring in the state. However, as recently as September 2014, Iowa had an issue with state film tax credits. Iowa aimed to be the nation's leader for state tax credits. However, mismanagement of the program five years ago led to the departure of many filmmakers in the state. The mismanagement came to light when an audit revealed that 26 million dollars of tax credits were improperly issued by Iowa's Department of Economic Development. As a result, the program closed and the state was forced to settle many of the claims.

Iowa is now trying to overcome this unfortunate and embarrassing debacle. It resolved many of the outstanding claims for the state film tax credits, which amounted to nearly 12 million dollars. Moving forward, the state has a new business model which has already seen some success in attracting individuals from the film industry.

**Historic rehabilitation.** As previously mentioned, tax credits available for the restoration of and investment in historic buildings have been available since 1978 on the federal level. On the state level, over 35 states have implemented similar programs. While the credits vary from state to state, most programs include similar elements. These include: criteria for what properties are eligible for the credit, standards with respect to the preservation, a method for determining the value of the credit, a minimum amount of investment for the project, and guidelines for the implementation of the program. Some state programs have been found to be more successful than others in stimulating rehabilitation activity and this often correlates with the statutory language delineated by the state legislature.

Most notable about the state historic rehabilitation tax credits is that these types of credits actually increase the use of their federal counterpart. Specifically, researchers have found that the presence of active state historic tax credits increases the use of the federal credit on average between 15 and 35
million dollars; this in turn means that states offering these types of credits bring in additional federal funds that otherwise would be unavailable. 32

**Brownfield remediation.** The term "Brownfields" typically refers to abandoned or underutilized commercial or industrial property where improvement or any redevelopment of the land is unlikely because of environmental contamination. Since the 1990s policies have been put in place, both at the federal and state level, in an attempt to remedy this problem.

Each state that offers Brownfield credits has identified an appropriate state environmental agency to handle and issue property certifications to taxpayers. Each state is responsible for providing taxpayers a written statement as to whether the specific property meets the definition of "qualified contaminated site" and whether there has been a release, threat of release or disposal of hazardous substances on the property.

**Renewable energy.** On the federal level, recent administrations have tried to encourage corporations to invest in clean energy by providing renewable energy tax credits. 33 There are several states that have followed the federal example, and now offer tax credits to companies that invest in renewable energy or energy conservation initiatives. These credits typically range from 35 to 50 percent of the costs. 34 The efforts encouraged by these types of tax credits typically include conservation and utilizing methods of energy that would reduce pollution.

**Breweries.** Recently, the State of New York began to offer a refundable tax credit for breweries. 35 These credits reimburse a company for its investment in the brewery regardless of whether the company is liable for any tax. This particular tax credit emerged from a New York court ruling which found that breweries are responsible for paying excise taxes. As a result of the ruling, the Governor and New York Legislature brokered a deal which would enable in-state breweries to utilize a tax credit to help offset the excise tax.

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**Methods of Monetization of State Tax Credits**

There are three basic monetization methods for state tax credits: (1) a state can refund the amount of a credit at the discount, (2) the state taxing authority can issue a tax credit certificate which can be sold to a third party, or (3) as outlined above, a limited partnership or syndication structure can be used.
Ohio, for example, offers a program that provides a refundable tax credit for job creation initiatives.  

This credit can be applied against many different state taxes imposed: commercial activity tax, insurance premiums tax, corporate franchise tax and personal income tax. Moreover, in the event the credit exceeds the taxpayer's tax liability, the state will issue the taxpayer a refund.

When selling a credit, determining an accurate price for the credit may be a difficult task. There are numerous factors that impact how accurate a determination can be made on credit value. Such factors include: possessing limited knowledge of the situation which generated the tax credit initially, the efficiency of the marketplace, the availability of credit transfer service providers, the level of understanding regarding the technicality and detail of the process of transferring credits, buyer indemnification and the possibility of recapture, and uncertainties with respect to the future of tax credits which may be affected by politics, administration and tax policy.

**Tax credit brokers.** Because an increasing number of states offer transferable state credits, a new market has emerged for tax credit brokers. These tax broker companies assist in matching buyers and sellers. Sometimes brokers simply buy the credits themselves and distribute them to companies after collecting a fee for the process. However, the process of brokering tax credits is not always easy and there are a myriad of potential problems.

While taxpayers may approach the brokers to find buyers for unused credits, the tax brokers must explain the risk to potential investors.  

There is always the risk that the credit may be rescinded by the appropriate taxing authority. If the credit was obtained through fraudulent business practices, states have the right to reclaim.

Moreover, the brokers have to ensure that the buyer owes taxes in the same state in which the seller has the credit. If the amount owed in taxes to a particular state is minimal, the use of the broker may not be worth the cost.

Arguably, most important is that the tax credits are sold for less than their full value. In order for the deal to be attractive to potential buyers, there must be a benefit from the transaction. Typically, sellers will receive 85 to 90 cents on the dollar for their credit. However, it is quite possible for sellers to receive less.

**Online Incentive Exchange.** The Online Incentive Exchange ("OIX") was founded in 2012 as a mechanism to remove tax credit brokers from the process. The founder, Danny Biegel, previously worked at the New York Stock Exchange for 15 years and is a former film producer. Given his background,
noted the potential market for matching sellers of transferrable tax credits to potential buyers and thus created the OIX. Membership in the online exchange is limited to institutional organizations or corporations. Individuals are only able to participate in the market through the use of a tax professional.

Thus far, the OIX, while based in New York City, only lists Louisiana tax credits. Currently, there are no figures on how many transactions have been completed; however, Biegel estimates that the value of credits already traded is well into the millions of dollars. When a buyer purchases a secondhand tax credit on the exchange the buyer purchases the credit at a reduced rate, typically 90 cents on the dollar. If a transaction is completed on the exchange, the OIX will take a fee (between two and five percent of the price) which is paid by the seller.

The exchange enables prospective buyers and sellers to compare prices in real time. Some participants prefer this to the use of brokers, because there is the guarantee that the price is at market as opposed to trusting a broker to formulate an accurate market price.

Moreover, the OIX attempts to review credits to ensure that they were not acquired through fraud or any illegal means. This review process is expected to minimize the risk of a state reclaiming the credit after it has been sold to a new party. This should decrease the risk for both parties and offer added protection that is not available through the use of brokers.

Advantages to transferring credits. The main advantage to the transferability of tax credits is that it creates an incentive for people to seek them and undertake activities deemed beneficial by the issuing state that otherwise would not be undertaken. If tax credits are worthless in a state, corporations may look outside the state to receive benefits. This could potentially cause loss of investment, reduced innovation and, arguably more importantly, a decrease in job creation in the state.

Some scholars suggest that, in some instances, a transferrable tax credit is the most beneficial type of tax credit. Specifically, if the taxpayer who holds the credit has a low tax liability, the taxpayer's credit is matched dollar-for-dollar to offset that liability, but then the taxpayer retains excess credit. Instead of allowing the credit to disappear, the taxpayer may sell the credit to another taxpayer so that the remainder of the credit can be used to offset the other taxpayer's tax liability.
Moreover, if the tax credit is simply refundable, the taxpayer has to wait until its taxes are filed to receive the refund. If the credit is transferable, the taxpayer is able to receive cash at any point in time when the credit is sold.

Disadvantages of transferring credits. With the transferability of credits, a business can receive a tax break for activity that the state never intended the credits to benefit. In 2012, Oklahoma considered eliminating the transferability element altogether and instead simply offer refundable credits. The Chairman of the Oklahoma House Appropriations and Budget Committee simply stated that, "if you [a taxpayer] do not have enough tax liability, you don’t get the credit."

If the credit is refundable, the state will issue the full amount of the unused portion. While the taxpayer will have to wait until it files its state tax return to receive a refund check, it will ultimately receive a greater amount of money than by selling the credit. This is because a tax credit is never sold for its full dollar amount. While the taxpayer can sell a transferable credit at any time, it will receive less than face value, not to mention incurring the cost of any broker or exchange used.

There are also some roadblocks when sellers wish to sell their credits on the open market. Often, states’ tax laws are complex and require the assistance of both accounting and tax professionals to facilitate the transfer and ensure that the parties are aware of the consequences; thus, it follows that the cost of selling a credit can be cumbersome and not necessarily worth it for some companies.

Taxation of Transferable Tax Credits

The Internal Revenue Service treats transferable tax credits the same as nontransferable credits until the point at which the credit is sold. When a credit is sold, it is treated as a sale of property and, consequently, the seller recognizes a gain (or loss) on the difference between the seller's amount realized and the seller's basis in the credit. The buyer then takes a cost basis in the credit, specifically, "[w]hen the buyer claims the credit on its state tax return, it is treated as transferring property in satisfaction of the amount of tax liability discharged by the credit. As a result, the buyer recognizes gain equal to the excess of the amount of the discharged tax liability over its basis in the credit, and has a deduction in the amount of the tax liability."

The U.S. Tax Court recently explored the issue of taxing credits in Tempel v. Commissioner. Tempel involved a married couple that petitioned for redetermination of an income tax deficiency that arose from
the sale of tax credits in Colorado. The couple donated a qualified conservation easement to a qualified charitable organization and, consequently, received tax credits from the State of Colorado. These credits were transferable, so the taxpayers sold a portion of the credit they received. The taxpayers claimed a short-term capital gain on the sale of the portion of the credit.

The IRS determined that the credit did not qualify as a capital asset, citing Gladden v Commissioner to support its contention that the gains from the sale must be ordinary in character. Gladden involved taxpayers selling water rights in exchange for cash. The court in Gladden used a six-factor test, now known as the Gladden factors, to determine the character of the taxpayer's gain on the sale of those rights. The IRS argued that the Gladden factors, if applied in Tempel, would lead the gain to be characterized as ordinary.

However, the U.S. Tax Court found that the IRS was overextending the applicability of the Gladden factors. Gladden was analyzed under contract law, and the court found that contract law was inapplicable in Tempel because "a government-granted tax credit is not a contract right." Therefore, the U.S. Tax Court found that the Gladden test does not extend its applicability to state tax credits.

In Tempel, the U.S. Tax Court found that the credits were capital assets but the gains in this situation qualified as short-term. The court also analyzed the issue of basis. The taxpayers argued that they possessed a cost basis in the state tax credits, which they calculated by adding in the professional costs of donating the property. The court disagreed and held that the taxpayers did not have a basis in the credit. In sum, the U.S. Tax Court found that receipt of a tax credit was not an accession to wealth; it simply represented a reduction in state tax liability.

After the decision in Tempel was rendered, the IRS issued a Chief Counsel Advice ("CCA") memorandum, which set forth advice regarding the sale of nonrefundable transferable state income tax credits. The CCA focuses on the tax consequences for the transfer of a Massachusetts tax credit.

The IRS stated that the sale of a tax credit is a taxable event. When the original recipient receives the credit it is not treated as realizing gross income under Section 61 of the Internal Revenue Code. However, if the credit is transferred to another taxpayer for some value, the original credit holder must recognize the gain received. The gain received is also capital in nature.

The IRS then reiterated a principle under Tempel, specifically, that because the original credit holder never purchased the credit, the taxpayer does not have any basis in the credit to offset any gain. The buyer's basis in the credit equals the amount of consideration paid.
It is important to note that the CCA was created in reference to nonrefundable tax credits. Both the court in *Tempel* and the IRS in the CCA found that a tax credit does not replace ordinary income, but simply reduces potential tax liability. The court found that gain on the sale or transfer of credits must be capital in nature. However, there still remain questions about the taxation of credits which are refundable.

**Conclusion**

Despite the attractive nature of tax credits, they are not without controversy. Critics argue that states spend too much money to incentivize businesses and that the money could be better spent in other arenas, such as education or healthcare. Others argue that states should completely eliminate all tax incentives and simply lower tax rates for everyone.

However, it is important to note that the ultimate goal of state tax credits is not in all cases to generate income for the state. Instead, state tax incentives are still seen as a tool to attract new and expanding businesses to the state, and to encourage certain activities or investment in the state.

Those that obtain tax credits may not have any, or enough, tax liability to which the total credits received may apply. But without at least a portion of the credit, the business may not survive or thrive, or the activity or investment deemed necessary may not be achieved. Therefore, to the extent state tax incentives exist, the sale or transferability of these incentives is arguably still necessary to the success of the state tax incentive programs.


3. *Id.*

4. Revenue Act of 1962, Pub. L. No. 87-834, § 2, 76 Stat. 960, 962-73. President Kennedy submitted to Congress alongside his budget proposals an explanation of the tax credit: "The tax credit increases the profitability of productive investment by reducing the net cost of acquiring new equipment. It will stimulate investment in capacity expansion and modernization, contribute to growth of our productivity and output,

5 I.R.C. § 46(c)(2) (1962). The rate was increased from seven percent to 10 percent in 1975.


7 Giegerich, *supra* note 4, at 721.

8 Revenue Act of 1978.


10 The Federal Low Income Housing Tax Credit, 26 U.S.C. § 42.


13 *Id.*

14 26 U.S.C. § 41(C)(1)(A). The depreciation deductions would need to be in accordance with the method prescribed by the Tax Reform Act of 1986 entitled the Modified Accelerated Cost Recovery System ("MACRS").


For the purposes of this article, the term "transferrable tax credit" refers to a credit "that may be conferred on a taxpaying entity other than the entity that qualifies for the benefit, thus allowing the qualifying entity to monetize the benefits."


Id.


Garrison, supra note 1.


California Film and Television Tax Credit Program, California Film Commission available at http://www.film.ca.gov/Incentives.htm.

26 Salama, supra note 23, at 1086.


30 Id.

31 Id.


33 Kathleen Caggiano, Incentives Watch: Are Transferable Tax Credits Going to Become a Thing of the Past, SALT Talk Blog (February 29, 2012).


36 The tax credit does not offset the excise tax in its entirety. However, in-state breweries will receive 14 cents per gallon credit for the first 500,000 gallons of beer brewed and then a four and a half cent credit on each gallon up to four and a half million gallons brewed. The legislation is aimed to assist smaller brewers, which were hit harder by the excise tax ruling.

38 Ohio Rev. Code Ann. § 122.17(B).

39 Goodman, supra note 22.


41 Id.


43 Id.

44 Tozzi, supra note 40.

45 Id.

46 Id.

47 Id.

48 Id.

49 Id.

50 Id.

51 Goodman, supra note 22.

52 Adam C. Kobos, Recent Developments in the Taxation of Transferable State Tax Credits, 38 WGL-CTAX 38, 38 (July/August 2011).

Tempel, 136 T.C. at 341.

Tempel, 136 T.C. at 348.

Gladden v. Commissioner, 112 T.C. 209, 218 (1999), rev'd on a different issue 262 F.3d 851 (9th Cir. 2001).

Tempel, 136 T.C. at 348.


C.C.A. 201147024 (Sep. 15, 2011).