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subject: Tax Treatment of Massachusetts State Tax Credits

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

ISSUES

1. When certain Massachusetts state tax credits are sold to a third party by the original recipient, is the sale of the tax credit a taxable event?
2. What is the basis of the tax credit to the original recipient?
3. Is gain to the original recipient capital or ordinary in nature?
4. What is the basis of the tax credit to the purchaser?
5. Should gain be recognized by the purchaser if the tax credit is purchased for less than its face value, and when should gain be recognized?

CONCLUSIONS

1. The sale of the tax credit is a taxable event.
2. The original recipient of the tax credit has no tax cost basis in the tax credit.
3. The original recipient’s gain on the sale of a nonrefundable credit is capital gain, unless the credit falls within one of the statutory exclusions in § 1221(a).
4. The purchaser’s basis for the tax credit is the cost of the tax credit.
5. The purchaser must recognize apportioned gain, if the tax credit is purchased for less than its face value, when the tax credit is used to satisfy state tax liability.

BACKGROUND

The Commonwealth of Massachusetts (the “state”) offers a number of state tax incentives in the form of tax credits as listed below.

1. Brownfields Tax Credit (Mass. Gen. Laws Ann. ch. 62, § 6(j) and ch. 63, § 38Q)

This tax credit is a non-refundable credit. It is available to certain eligible taxpayers who, in general, commence, pursue, and maintain an environmental response action on or before August 15, 2013, provided they achieve a permanent solution or remedy operation status that has eliminated a condition of any substantial hazard to public health, safety, welfare or the environment. Depending on whether a taxpayer satisfied certain requirements, in general, the tax credit is (1) 25% of the net response and removal costs incurred between August 1, 1998 and January 1, 2014, or (2) 50% of the net response and removal costs. A taxpayer may transfer all or a portion of the credit it earns to a taxpayer with certain state tax liability or to a nonprofit organization.

2. Motion Picture Tax Credit (Mass. Gen. Laws Ann. ch. 62, §§ 6(l) and 6L, ch. 63, §§ 38X and 32E)

This credit is available to a taxpayer engaged in the making of a motion picture within the state. The credit consists of a payroll credit and a production expense credit. Regarding the payroll credit, in general, a taxpayer is entitled to a credit of 25% of the total qualifying aggregate payroll for the employment of persons within the state in connection with the filming and production of a motion picture. Regarding the production expense credit, in general, a taxpayer is allowed to claim a credit equal to 25% of the state production expenses so long as such taxpayer is eligible to claim the payroll credit in connection with the same motion picture.

A taxpayer is entitled to a partial refund of the credit. If a taxpayer chooses, after applying the credit to its state tax liability, a taxpayer can obtain a refund of 90% of any remaining credit by providing the commissioner with a written election to do so. A taxpayer may transfer, sell, or assign all or a portion of the credit it earns to a taxpayer with certain state tax liability.

3. Historic Rehabilitation Tax Credit (Mass. Gen. Laws Ann. ch. 62, § 6J and ch. 63, § 38R)

In general, a taxpayer that incurs qualified rehabilitation expenditures in connection with certified rehabilitation of a qualified historic structure is allowed a credit of up to 20% of the cost of the certified rehabilitation expenditures. This credit is not refundable and may be carried forward for a maximum of five years.

The taxpayer may transfer the credit, in whole or in part, to any individual or entity, and the transferee shall be entitled to apply the credit against the tax with the same effect as if the transferee had incurred the qualified rehabilitation expenditures itself.

4. Low-Income Housing Tax Credit (Mass. Gen. Laws Ann. ch. 62, § 6I and ch. 63, § 31H)

This credit is available to a taxpayer with respect to certain qualified low-income housing projects located in the state. In general, the amount of the credit is based on availability, and the standards and requirements as set forth in § 42 of the 1986 Internal Revenue Code, provide that the combined federal and the state tax credits shall be the least amount necessary to ensure financial feasibility. This tax credit is not refundable.

All or a portion of the tax credit may be transferred, sold, or assigned to parties who are taxpayers of the state eligible to claim a federal low-income housing tax credit with respect to the original or a different qualified project.

5. Medical Device Tax Credit (Mass. Gen. Laws Ann. ch. 62, § 6½ and ch. 63, § 31L)

In general, a medical device company may claim a non-refundable tax credit equal to 100% of the user fees paid to the United States Food and Drug Administration during the taxable year for which the tax is due for a pre-market approval to market new technologies developed or manufactured in the state or for a clearance to market upgrades, changes or enhancements to existing technologies that are developed or manufactured in the state.

A medical device company may transfer the credit in exchange for private financial assistance to assist in the funding of costs incurred by the medical device company. The private financial assistance shall be used to fund expenses incurred in connection with the operation of the medical device company in the state. The financial assistance provided by the transferee must be equal to at least 75% of the medical device tax credit amounts eligible for transfer.

LAW AND ANALYSIS

1. Is the sale of the tax credit a taxable event?

Section 61 of the Internal Revenue Code provides generally that, except as otherwise provided by law, gross income includes all income from whatever source derived.

Section 1001(a) provides that the gain from the sale or other disposition of property is the excess of the amount realized over the adjusted basis provided in § 1011 for determining gain, and the loss is the excess of the adjusted basis provided in § 1011 for determining loss over the amount realized. Section 1001(b) defines the amount

realized from the sale or other disposition of property as the sum of any money received plus the fair market value of any property received. Section 1001(c) provides that, except as otherwise provided in subtitle A, the entire amount of the gain or loss on the sale or exchange of property must be recognized.

Section 1.1001-1(a) of the Income Tax Regulations provides that, except as otherwise provided in subtitle A, the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained.

The taxpayer that originally receives – that is, qualifies for – one or more of the described credits is not viewed as having received property in a transaction that results in the realization of gross income under § 61. Generally, a state tax credit, to the extent that it can only be applied against the original 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, not as a payment of cash or property to the taxpayer that is includible in gross income under § 61. The amount of the tax credit is not included in the taxpayer's federal gross income, or otherwise treated as a payment from the state. Rev. Rul. 79-315, 1979-2 C.B. 27. Consequently, the federal tax effect of such a state tax credit is normally to reduce any deduction for payment of state tax the taxpayer may otherwise have had under § 164.[1] By itself, the fact that a state tax credit is transferable does not cause it to lose its character as a reduction or potential reduction in liability in the hands of the taxpayer who originally qualified for the credit.[2]

However, if and when a transferable tax credit is transferred to another taxpayer for value, the original recipient must recognize the gain because the transaction is a sale for purposes of § 1001. *See Tempel v. Commissioner*, 136 T.C. No. 15 (2011).

<u>2. What is the basis of the tax credit to the original recipient?</u>

[1] We note that some taxpayers have taken the position that a state or local tax credit, exemption, or similar tax benefit can be treated for federal tax purposes as a deemed payment from the government that does not reduce the original recipient's § 164 deduction and that may be excludible from income, in some circumstances, as a contribution to the capital of a corporate taxpayer within the meaning of § 118. Although a full discussion of this issue is outside the scope of this memorandum, we do not agree that a such a reduction in a taxpayer's potential tax liability is the equivalent of a payment to the taxpayer, includible in gross income unless it is excludible under § 118 or some other provision; instead, as stated in the text, in the hands of the taxpayer that originally qualifies for the benefit, it simply enters into the computation of the taxpayer's state or local tax liability and is reflected in the amount of the taxpayer's § 164 deduction. *See* Rev. Rul. 79-315 and other authorities discussed in Coordinated Issue Paper LMSB-04-0408-023 (May 23, 2008).

[2] We note that the transferable, partially refundable motion picture tax credit has the same character as the transferable, nonrefundable credits at the time a taxpayer qualifies for it.

Section 1012 provides in general that the basis of property shall be the cost of the property. Section 1.1012-1(a) defines cost to be the amount paid for the property in cash or other property.

The original recipient did not purchase the tax credit. It was the state's unilateral decision to grant the tax credit as a consequence of the original recipient's compliance with one of the state statutes. Accordingly, the original recipient generally has no tax cost basis in the tax credit. *See Tempel*, 136 T.C. No. 15.

3. Is gain to the original recipient capital or ordinary in nature?

Under § 1222, capital gain results from the sale or exchange of a capital asset. The sale of a transferable state tax credit is a "sale or exchange" of the credit for § 1222 purposes.

The term "capital asset" is statutorily defined in § 1221 as property held by the taxpayer, whether or not connected with the taxpayer's trade or business, unless the property meets one of eight exceptions listed in § 1221(a).

In addition, the Supreme Court has stated "it is evident that not everything which can be called property in the ordinary sense and which is outside the statutory exclusions qualifies as a capital asset"; rather, "the term 'capital asset' is to be construed narrowly in accordance with the purpose of Congress to afford capital-gains treatment only in situations typically involving the realization of appreciation in value accrued over a substantial period of time, and thus to ameliorate the hardship of taxation of the entire gain in one year." *Commissioner v. Gillette Motor Transport, Inc.*, 364 U.S. 130, 134 (1960). *See also Commissioner v. P.G. Lake, Inc.*, 356 U.S. 260 (1958); *United States v. Midland-Ross Corp.*, 381 U.S. 54, 57 (1965); *Arkansas Best Corp. v. Commissioner*, 485 U.S. 212, 217 n.5 (1988).

In applying *Gillette* and related authority, courts have cited to a number of factors derived from case law, including how the transferred rights in question originated; how they were acquired; whether they represented an equitable interest in property which itself constituted a capital asset; whether the transfer of rights merely substituted the source from which the taxpayer otherwise would have received ordinary income; whether significant investment risks were associated with the rights and, if so, whether they were included in the transfer; and whether the rights primarily represented compensation for personal services. *See Foy v. Commissioner*, 84 T.C. 50, 70 (1985); *see also Gladden v. Commissioner*, 112 T.C. 209, 221 (1999), *rev'd on other issue*, 262 F.3d 851 (9th Cir. 2001).

In *Tempel v. Commissioner*, 136 T.C. No.15 (2011), the taxpayers sold excess transferable charitable conservation-easement tax credits provided by the State of Colorado and treated the proceeds as short term capital gains on their 2004 and 2005 returns. In the Tax Court, the Service and the taxpayer agreed that the credits did not

fall within any of the statutory exceptions in § 1221(a). The Service argued that the sales proceeds were ordinary income because, applying the multi-factor test under *Gillette* and related case law, the credits were ordinary assets. The taxpayers continued to assert the position that the credits were capital assets, but for the first time claimed they were entitled to long-term capital gains treatment. The court held that the credits were capital assets, reasoning that the amount realized from the sale was not a substitute for ordinary income, and that the multi-factor analysis recognized in cases like *Foy* and *Gladden* only applies to the analysis of contract rights. *See Tempel*, Slip Op. at 7-20; *see also McNeil v. Commissioner*, T.C. Memo. 2011-109. The court found that taxpayers' holding period in their credits began at the time the credits were granted and ended when petitioners sold them. Because the credits were sold in the same month they were received, the court held the capital gains from their sale were short term.

We do not agree with the reasoning in *Tempel* that the multi-factor analysis in cases like *Foy* and *Gladden* applies only when there are contract rights at issue. For example, the Tax Court and several other courts, applying the multi-factor analysis, have repeatedly held that a right to state lottery winnings is not a capital asset. *See Davis v. Commissioner*, 119 T.C. 1 (2002); *see also Watkins v. Commissioner*, 447 F.3d 1269 (10th Cir. 2006); *Lattera v. Commissioner*, 437 F.3d 399 (3d Cir. 2006); *United States v. Maginnis*, 356 F.3d 1179 (9th Cir. 2004). We do not think that the result or the analysis in such cases depends on whether state lottery rights are viewed as statutory or contractual in nature. Generally, adoption of one test for contract rights and another, undefined test for other types of property would not further consistent application of the tax law.

However, we accept the conclusion of the Tax Court in *Tempel* and *McNeil*, which the court could have reached under the established multi-factor test, that a nonrefundable[3] state tax credit that does not fall within the statutory exclusions in § 1221(a) is a capital asset for purposes of § 1221.[4]

Accordingly, a taxpayer that qualified for one of the nonrefundable Massachusetts state tax credits described above would realize capital gain on the sale of the credit, unless the credit fell within one of the statutory exclusions in § 1221(a).[5]

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[3] Although the Colorado tax credit at issue in *Tempel* was refundable in some circumstances, the court found that the taxpayers in the actual case could not use the credit they sold to produce a refund in excess of their tax liability.

[4] Note that, as the Tax Court held, the credit is a capital asset in itself, not by virtue of its relationship to another asset. We agree with the *Tempel* court's rejection of the taxpayers' argument that a charitable conservation easement credit is an interest in the real property that was the subject of the easement, and therefore inherits the character, basis, or holding period of the real property. *See* Slip. Op. at 20-26.

[5] We would want to review the facts of an actual sale by a specific taxpayer before expressing an opinion on whether the Massachusetts motion picture tax credit, which is partially refundable, is a capital asset.

4. What is the basis of the tax credit to the purchaser?

Section 1012 provides in general that the basis of property shall be the cost of the property. Section 1.1012-1(a) defines cost to be the amount paid for the property in cash or other property.

Section 1.263(a)-4 provides rules for applying § 263(a) to amounts paid to acquire or create intangibles. Section 1.263(a)-4(e) provides rules for the treatment of amounts paid to facilitate the acquisition or creation of an intangible.

The purchaser's basis of the tax credit is the consideration paid by the purchaser to acquire the tax credit. In addition, any transaction costs incurred in acquiring the tax credit are includible in the basis of the tax credit, unless they qualify as de minimis costs under § 1.263(a)-4(e)(4)(iii).

5. Should gain be recognized by the purchaser if the tax credit is purchased for less than its face value, and when should gain be recognized?

Section 61(a)(3) defines gross income to include "gains derived from dealings in property." Section 1.61-6(a) states that "gain is the excess of the amount realized over the unrecovered cost or other basis for the property sold or exchanged," adding:

> When a part of a larger property is sold, the cost or other basis of the entire property shall be equitably apportioned among the several parts, and the gain realized or loss sustained on the part of the entire property sold is the difference between the selling price and the cost or other basis allocated to such part. The sale of each part is treated as a separate transaction and gain or loss shall be computed separately on each part. Thus, gain or loss shall be determined at the time of sale of each part and not deferred until the entire property has been disposed of.

With respect to the purchaser of the tax credit, a payment for the purchase of a transferable tax credit is not a payment of tax or a payment in lieu of tax for purposes of § 164(a). *See* Rev. Rul. 61-152, 1961-2 C.B. 42; Rev. Rul. 71-49, 1971-1 C.B. 103; Rev. Rul. 81-192, 1981-2 C.B. 50. Rather, the purchaser has purchased a valuable right, the basis of which is the cost incurred. For federal tax purposes, the use of the tax credit to satisfy the purchaser's state tax liability is a transfer of property to the state in satisfaction of the liability, not a reduction in the liability. Accordingly, in the year or years the purchaser applies the tax credit to satisfy its state tax liability, the purchaser will realize gain or loss under § 1001 equal to the difference, if any, between the basis of the tax credit and the amount of liability satisfied by the application of the tax credit. In addition, the purchaser will be treated as having made a payment of state tax for purposes of § 164(a). *See* Rev. Rul. 86-117, 1986-2 C.B. 157.

The purchaser recognizes and reports the gain as the tax credits are used, not when the tax credits are purchased. For example, if the purchaser pays $80 for a tax credit that has a "face value" of $100 in Year 1 and uses half of the tax credit with a basis of $40 to satisfy its $50 state tax liability in Year 2, the purchaser would recognize and report the gain in the amount of $10 in Year 2.

If you have any questions regarding §§ 61, 1001 and 1012, please call Seoyeon Sharon Park (CC:ITA:5) at (202) 622-4960; and if you have any questions regarding §§ 263, 1221, and 1222, please call Robert Basso (CC:ITA:3) at (202) 622-4950.