

**FEDERAL INCOME TAX CONSEQUENCES OF  
STATE ECONOMIC DEVELOPMENT  
INCENTIVES  
AFTER PASSAGE OF TAX CUTS AND JOBS ACT**

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## **I. General**

South Carolina has a rich mix of economic development incentives. These include income tax credits, sales tax exemptions, property tax exemptions and credits as well as withholding tax credits. Incentives also include cash grants, e.g., Department of Commerce Set Aside Funds, and the occasional county grant. The state or county may also directly pay for or contribute land or public infrastructure to benefit an economic development project. South Carolina TIF statutes may result in substantial funds benefiting private real estate developers. Can the receipt of these incentives trigger federal income tax liability to the fortunate recipient?

On May 23, 2008, the Internal Revenue Service issued Coordinated Issue Paper LMSB-04-0404-023 (CIP) addressing its position as to the federal tax treatment of certain state and local tax incentives. The state and local tax incentives covered are referred to as “location incentives.” These types of incentives include abatements, credits, tax rate reductions and exemptions which are used by state and local governments to induce companies to relocate, expand or maintain facilities in a particular area.

As stated in *IRS Tier I Issue: IRS Section 118 Abuse Directive #4*, the IRS issued this CIP not to declare incentives as taxable income but rather to counteract a strategy used by some corporate taxpayers of claiming a current federal income tax deduction for the full state or local tax incentive amount as if that amount had actually been paid by the taxpayer as a state and local tax (e.g. deducting taxes on a fee-in-lieu as if there was a 10.5% assessment ratio rather than the 6% ratio contained in the fee). Under this strategy, the corporate taxpayer under the former law would recognize the incentive amount as gross income for federal purposes, but not as taxable income because, as discussed below, (under the former law) such amount would be treated as a

contribution to the taxpayer's capital. In essence, the corporate taxpayer would get the federal tax deduction without any corresponding taxable income.<sup>1</sup>

The IRS concluded in its CIP that such state and local tax incentives generally (1) did not result in federal gross income to the recipient *corporate* taxpayer; (2) were not a contribution to the taxpayer's capital; (3) did not reduce the taxpayer's basis in its property; and (4) were not allowed as a deduction for taxes that are paid or accrued. Alas, the IRS's interest in state tax incentives did not end there. On November 3, 2017, the IRS included "Economic Development Incentives" as part of its eleven Large Business & International ("LB&I") Compliance Campaigns to ensure compliance with section 118 of the prior law.

The IRS did prior to the current law consider receipt of some incentives as subject to federal income taxes, most recently in *Ginsberg v. United States, F.Cl. (17-CV-00075)(2018)* and *Maines v. CIR*, 144 T.C. No. 8 (Tax Court 2015); and the IRS considered receipt of some incentives by non-corporate entities as taxable income.

At the end of 2017, the U.S. Congress adopted H.R. 1, commonly referred to as the "Tax Cuts and Jobs Act,"<sup>2</sup> which has substantially changed the rules for corporations.

This article summarizes the general principals of incentives as subject to federal income taxes, under the new (and old) law and attempts to apply those principals to South Carolina's incentives. The article discusses receipt of incentives by both corporations as well as LLCs and other entities. The article also discusses the exceptions to taxability which remain in place.

The granting of incentives by state and local government is now more in the public eye than in previous years. GASB 77, which requires the disclosure of certain incentives by state

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<sup>1</sup> See IRS ATG on *State, Local Location Tax Incentives under Section 118*.

<sup>2</sup> Senate Democrats challenged the name "Tax Cuts and Jobs Act" under the Byrd Rule and the new official Title is "An Act to provide for the reconciliation pursuant to titles II and V of the concurrent resolutions on the budget for fiscal year 2018." Naturally, we will refer to it as the Tax Cuts and Jobs Act, or H.R. 1.

and local governments became effective on December 31, 2015 and will be included for the first time in State and Local Government Annual Reports for FY 2016-17. Many of these Reports will be posted online from November 2017 through early 2018. State and Local governments may report the granting of incentives under GASB 77 on either an aggregate or per-project basis, although the vast majority will report on an aggregate basis. Many Commerce Departments report State and Local Government grants and other incentives in an Annual Report, which is also typically posted online as well.

## **II. Receipt of Incentives by Corporations**

### **A. Former Law**

IRC Section 61(a) provides that, except as otherwise provided, gross income means all the income from whatever source derived. Section 1-61-1(a) of the Income Tax Regulations provides that “[g]ross income means all income from whatever source derived unless excluded by law. Gross income includes income realized in any form, whether in money, property, or services.”

The US Supreme Court held that governmental grants to corporations for economic development purposes were not income within the meaning of IRC §61 in *Edwards v. Cuba Railroad Co*<sup>3</sup>. In *Cuba Railroad*, the corporation received subsidy payments from the Republic of Cuba to build a railroad. Cuba made the payments proportionate to the millage of railroad constructed and the taxpayer credited them to a capital expenditure account. The Supreme Court held that the subsidy payments were not income because the payments were made in proportion to the millage completed. The Court held that payments in proportion to the millage completed

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<sup>3</sup> *Edwards v. Cuba Railroad Co.*, 268 U.S. 628 (1925).

simply reimbursed the taxpayer for capital expenditures incurred and to provide for the development of resources in the territory to be served.

The Supreme Court then decided three cases *Detroit Edison v. Commissioner*<sup>4</sup>, *Brown Shoe Co. v. Commissioner*<sup>5</sup>, and *United States v. Chicago, Burlington & Quincy R.R. Co.*<sup>6</sup> which addressed the question of whether taxpayers could depreciate assets contributed by non-shareholders and/or assets purchased with funds contributed by non-shareholders. The rulings in these cases impacted the definition of a non-shareholder contribution to capital and provided guidance concerning capital contributions and income received in exchange for the performance of services.

In *Detroit Edison*, the Court held that payments made by prospective customers to an electric utility to cover the cost of extending the utility's facilities to the customers' homes were part of the price of services and not contributions to capital. The Court found that the customers did not intend to make contributions to the taxpayer's capital and regarded the payments as the price of services, stating, "it overtaxes imagination to regard the farmers and other customers who furnished these funds as makers either of donations or contributions to the Company."<sup>7</sup>

In *Brown Shoe Co.*, the Court held that payments to a corporation by community groups to induce the location of a factory in their community represented a contribution to capital. The Court reasoned:

Since in this case there are neither customers nor payments for service, we may infer a different purpose in the transactions between petitioner and the community groups. The contributions to petitioner were provided by citizens of the respective communities who neither sought nor could have anticipated any

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<sup>4</sup> 319 U.S. 98 (1943).

<sup>5</sup> 339 U.S. 583 (1950).

<sup>6</sup> 412 U.S. at 401.

<sup>7</sup> *Id.* at 102.

direct service or recompense whatever, their only expectation being that such contributions might prove advantageous to the community at large. Under these circumstances the transfers manifested a definite purpose to enlarge the working capital of the company.<sup>8</sup>

The US Supreme Court provided clarity on whether incentives could be excluded from income in *U.S. v. Chicago Burlington & Quincy R.R. Co*<sup>9</sup>. The Court adopted a two-party inquiry to identify a non-shareholder's (e.g. governmental unit) contribution to capital of a private corporation: (1) the intent or motive of the governmental unit; and (2) the economic effect on the transferee corporation. The governmental unit's intent must be to enlarge the transferee corporation; provide capital to expand its trade or business for the benefit of the community at large and not to give a direct or specific benefit for the transferor. For the requisite economic effect in the transferee corporation, the following five factors must have been present: (1) the contribution must become a permanent part of the transferee's working capital structure; (2) the contribution may not be compensation, such as a direct payment for a specific quantifiable service provided for the transferor by the transferee; (3) the contribution must be bargained for; (4) the contributed asset foreseeably must result in benefit to the transferee in an amount commensurate with its value; and, (5) the contributed asset ordinarily, if not always, will be employed in or contribute to the production of additional income.

The IRS used these five factors in determining whether a grant or other payment constituted a Section 118(a) non-shareholder contribution of capital.

Congress finally stepped in and enacted IRC §118 in 1954. Regulation 1.118-1 now provides:<sup>10</sup>

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<sup>8</sup> Id. At 591.

<sup>9</sup> *U.S. v. Chicago, B. & Q. R. Co.*, 412 U.S. 401 (1973).

<sup>10</sup> Presumably the IRS will update this Regulation.

Contributions to the capital of a corporation.

In the case of a corporation, section 118 provides an exclusion from gross income with respect to any contribution of money or property to the capital of the taxpayer. . . . Section 118 also applies to contributions to capital made by persons other than shareholders. For example, *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. (Emphasis added.)

In summary, governmental grants given to corporations prior to H.R. 1 were generally not considered taxable income. Even if they were included in gross income, they were excluded from taxation under IRS section 118.<sup>11</sup>

Congress enacted section 118 to codify judicial decisions dealing with income taxes and simultaneously enacted section 362(C), which assigns a zero basis to corporate property acquired through governmental grants. The net effect was to allow the exclusion of the grant from gross income, while prohibiting the taxpayers from adding the value of the grant to the basis of the asset. Congress did not likely consider the business entity issue when it enacted section 118 in 1954. Very few businesses of the type likely eligible for economic development incentives in 1954 were general or limited partnerships and LLCs were not recognized by any state until Wyoming in 1977.

## **B. Current Law**

On December 22, 2017, President Trump signed into law H.R. 1, the Tax Cuts and Jobs Act.<sup>12</sup> The legislation made significant changes to the taxation of incentives (principally grants and gifts of land) received by corporations. As discussed below, the House bill contained a

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<sup>11</sup> See generally, 501-4<sup>th</sup> TMP, *Gross Income: Overview and Conceptual Aspects*, 1X.B.5.b(2)(6).

<sup>12</sup> See Footnote one for official name.

section making certain incentives taxable to a corporation. (The Ways & Means Committee said that its change would increase revenues by \$7.4 billion over 2018-2027!) The Senate version was silent, and the Conference Committee amended the House language. The section in the House bill read as follows:

## **SEC. 76. CONTRIBUTIONS TO CAPITAL.**

“(a) In General.—*Gross income includes any contribution to the capital of any entity.*

“(b) Treatment Of Contributions In Exchange For Stock, Etc.—

“(1) IN GENERAL.—In the case of any contribution of money or other property to a corporation in exchange for stock of such corporation—

“(A) such contribution shall not be treated for purposes of subsection (a) as a contribution to the capital of such corporation (and shall not be includible in the gross income of such corporation), and

“(B) no gain or loss shall be recognized to such corporation upon the issuance of such stock.

“(2) TREATMENT LIMITED TO VALUE OF STOCK.—For purposes of this subsection, a contribution of money or other property to a corporation shall be treated as being in exchange for stock of such corporation only to the extent that the fair market value of such money and other property does not exceed the fair market value of such stock.

“(3) APPLICATION TO ENTITIES OTHER THAN CORPORATIONS.—In the case of any entity other than a corporation, rules similar to the rules of paragraphs (1) and (2) shall apply in the case of any contribution of money or other property to such entity in exchange for any interest in such entity.

“(c) Treasury Stock Treated As Stock.—Any reference in this section to stock shall be treated as including a reference to treasury stock.”

(b) Basis Of Corporation In Contributed Property.—

(1) CONTRIBUTIONS TO CAPITAL.—Subsection (c) of [section 362](#) is amended to read as follows:

“(c) Contributions To Capital.—If property other than money is transferred to a corporation as a contribution to the capital of such corporation (within the meaning of section 76) then the basis of such property shall be the greater of—

“(1) the basis determined in the hands of the transferor, increased by the amount of gain recognized to the transferor on such transfer, or



“(2) the amount included in gross income by such corporation under section 76 with respect to such contribution.”.

(2) CONTRIBUTIONS IN EXCHANGE FOR STOCK.— Paragraph (2) of [section 362\(a\)](#) is amended by striking “contribution to capital” and inserting “contribution in exchange for stock of such corporation (determined under rules similar to the rules of paragraphs (2) and (3) of section 76(b))”.

(c) Conforming Amendments.—

(1) [Section 108\(e\)](#) is amended by striking paragraph (6).

(2) Part III of subchapter B of [chapter 1](#) is amended by striking section 118 (and by striking the item relating to such section in the table of sections for such part).

(3) The table of sections for part II of subchapter B of [chapter 1](#) is amended by inserting after the item relating to section 75 the following new item:

[“Sec. 76. Contributions to capital.”](#)

(d) Effective Date.—The amendments made by this section shall apply to contributions made, and transactions entered into, after the date of the enactment of this Act. (Emp. added).

The Committee on Ways & Means explained this section as follows:

**Sec. 3304. Revision of treatment of contributions to capital.**

**Current law:** Under current law, the gross income of a corporation generally does not include contributions to its capital (*i.e.*, transfers of money or property to the corporation by a non-shareholder such as a government entity). In addition, a corporation does not recognize gain or loss on the receipt of money or property in exchange for stock of the corporation.

**Provision:** Under the provision, the gross income of a corporation would include contributions to its capital, to the extent the amount of money and fair market value of property contributed to the corporation exceeds the fair market value of any stock that is issued in exchange for such money or property. Similar rules would apply to contributions to the capital of any non-corporate entity, such as a partnership. The provision would be effective for contributions made, and transactions entered into, after the date of enactment.

**Consideration:** This provision would remove a Federal tax subsidy for State and local governments to offer incentives and concessions to businesses that locate operations within their jurisdiction (usually in lieu of locating operations in a different State or locality).

**JCT estimate:** According to JCT, the provision would increase revenues by \$7.4 billion over 2018-2027.

Much of the House section dealt with contributions of property in exchange for stock, which, of course, does not apply to economic development incentives given by a governmental unit. The Conference Committee on the bill retained but amended the House section. The section in final version reads as follows:

**SEC. 13312. CERTAIN CONTRIBUTIONS BY GOVERNMENTAL ENTITIES NOT TREATED AS CONTRIBUTIONS TO CAPITAL.**

(a) In General.—[Section 118](#) is amended—  
(1) by striking subsections (b), (c), and (d),  
(2) by redesignating subsection (e) as subsection (d), and  
(3) by inserting after subsection (a) the following new subsections:

“(b) Exceptions.—For purposes of subsection (a), *the term ‘contribution to the capital of the taxpayer’ does not include—*

“(1) any contribution in aid of construction or any other contribution as a customer or potential customer, and

“(2) *any contribution by any governmental entity or civic group (other than a contribution made by a shareholder as such).*

“(c) Regulations.—The Secretary shall issue such regulations or other guidance as may be necessary or appropriate to carry out this section, including regulations or other guidance for determining whether any contribution constitutes a contribution in aid of construction.”.

(b) Effective Date.—

(1) IN GENERAL.—Except as provided in paragraph (2), the amendments made by this section shall apply to contributions made after the date of enactment of this Act.

(2) EXCEPTION.—The amendments made by this section shall not apply to any contribution, made after the date of enactment of this Act by a governmental entity, which is made pursuant to a master development plan that has been approved prior to such date by a governmental entity. (Emp. added).

The Conference Committee Report discusses the final version as follows:

**PRESENT LAW** - The gross income of a corporation does not include any contribution to its capital. For purposes of this rule, a contribution to the capital of a corporation does not include any contribution in aid of construction or any other contribution from a

customer or potential customer. A special rule allows certain contributions in aid of construction received by a regulated public utility that provides water or sewerage disposal services to be treated as a tax-free contribution to the capital of the utility. No deduction or credit is allowed for, or by reason of, any expenditure that constitutes a contribution that is treated as a tax-free contribution to the capital of the utility. If property is acquired by a corporation as a contribution to capital and is not contributed by a shareholder as such, the adjusted basis of the property is zero. If the contribution consists of money, the corporation must first reduce the basis of any property acquired with the contributed money within the following 12-month period, and then reduce the basis of other property held by the corporation. Similarly, the adjusted basis of any property acquired by a utility with a contribution in aid of construction is zero.

HOUSE BILL - The provision repeals the provision of the Internal Revenue Code under which, generally, a corporation's gross income does not include contributions of capital to the corporation. The provision provides that a contribution to capital, other than a contribution of money or property made in exchange for stock of a corporation or any interest in an entity, is included in gross income of the corporation. *For example, a contribution of municipal land by a municipality that is not in exchange for stock (or for a partnership interest or other interest) of equivalent value is considered a contribution to capital that is includable in gross income.*

By contrast, a municipal tax abatement for locating a business in a particular municipality is not considered a contribution to capital.

The provision further provides that a contribution of capital in exchange for stock is not includible in the gross income of the corporation to the extent that the fair market value of any money or other property contributed does not exceed the fair market value of stock received. It is intended that, for this purpose, the fair market value of any property contributed is calculated net of any liabilities to which the property is subject and net of any liabilities or obligations of the transferor assumed or taken subject to by the entity in connection with the transaction. When valuing stock or equity received, taxpayers may disregard discounts for lack of control and the effect of limited liquidity on valuation.

The fair market value requirement generally will be satisfied in any arm's length transaction in which stock is issued in consideration for cash. Thus, for example, in a public offering, if

the price of the stock was determined on an arm's length basis, the fact the stock trades immediately after its issuance at a price below the issue price will not result in contribution to capital treatment.

Finally, the provision provides rules clarifying the contributee's basis in the property contributed. Effective date.—The provision applies to contributions made, and transactions entered into, after the date of enactment.

SENATE AGREEMENT – No provision.

CONFERENCE AGREEMENT - The conference agreement follows the policy of the House bill but takes a different approach. The conference agreement does not repeal the provision of the Internal Revenue Code under which, generally, a corporation's gross income does not include contributions to capital. Rather, it preserves that provision, but provides that the term "*contributions to capital*" does not include (1) any contribution in aid of construction or any other contribution as a customer or potential customer, and (2) *any contribution by any governmental entity or civic group* (other than a contribution made by a shareholder as such). The conferees intend that section 118, as modified, continue to apply only to corporations.

Effective date.—The provision applies to contributions made after the date of enactment. However, the provision shall not apply to any contribution made after the date of enactment by a governmental entity pursuant to a master development plan that has been approved prior to such date by a governmental entity. (Emp. added).

As such, the new federal bill repeals the prior exclusion to income under section 118 which applied "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 [or expand] its business in a particular community."<sup>13</sup>

### **C. Effective Date**

The final bill contains the following effective date provision:

(b) Effective Date.—

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<sup>13</sup> Reg. 1.118-1.

(1) IN GENERAL.—Except as provided in paragraph (2), the amendments made by this section shall apply to contributions made after the date of enactment of this Act.

(2) EXCEPTION.—The amendments made by this section shall not apply to any contribution, made after the date of enactment of this Act by a governmental entity, which is made pursuant to a master development plan that has been approved prior to such date by a governmental entity.

The effective date provision states that the new law applies to "contributions made after the date of enactment of this Act," i.e., December 22, 2017. It is likely to raise a host of issues. It is quite common for Grants in South Carolina and across the country to disburse funds over a period of time. A grant formally awarded in 2015 may not have funds disbursed until 2018 and thereafter. Are the 2018 disbursements taxable for accrual basis taxpayers?

The Act does have a grandfather clause for contributions made after December 22, 2017 "which is made pursuant to a master development plan that has been approved prior to such date by a governmental entity." While the term "master development plan" is commonly used in a variety of contexts, it is actually not a defined term nor a term of art. There is no definition of it in Black's Law Dictionary, Wikipedia or several leading dictionaries.

The term is commonly used in real estate developments (commercial and residential), many of which have their plans approved by the property owners but not by local governments.

In South Carolina, a "master development plan" would presumably include a Planned Unit Development (PUD), a Planned Development District (PDD) a South Carolina Land Development Agreement, and a TIF Redevelopment Plan, all of which are approved by local governments.

The Council for the District of Columbia enacted an Act "to clarify what constitutes a master development plan that has been approved by a governmental entity for purposes of Section 118 of the Internal Revenue Code." The Act states that "[t]he following are recognized

as master development plans that have been approved by a governmental entity within the meaning of section 118" and includes Planned unit development projects, Development Plans for projects that have received approval from the Zoning Commission, neighborhood or area development or revitalization plans, a development plan to be funded in whole or in part with a tax increment financing approved by the Council or "[a]ny other development plan, redevelopment plan, revitalization plan, or similar plan designated by the Mayor that was approved before the effective date of section 13312 of an Act..." While this Act is not binding on the IRS,<sup>14</sup> it may prove helpful given that "Master Development Plan" is neither a defined term nor term of Art.

### **III. Receipt of Incentives by Partnerships and LLCs**

#### **A. No Section 118 Exclusion**

In a 1972 Revenue Ruling<sup>15</sup>, the IRS held that consideration paid to a non-corporate entity for membership certificates were not includable in gross income and should be treated as contribution to capital under section 118. The 1972 Revenue Ruling provided no explanation why section 118 applied to a non-corporate entity. Similarly, in a 1979 Technical Advice Memorandum<sup>16</sup> the IRS held that a governmental grant to a non-corporate taxpayer, a public utility partnership, qualified for section 118 exclusion under the *Chicago, Burlington and Quincy Railroad Co.*, five prong test. Lastly, in a 1980 PLR<sup>17</sup> the IRS held that governmental grants given to a limited partnership for the construction of a hotel and residential units were excludable from gross income as they represented a contribution to the capital of the partnership.

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<sup>14</sup> See, e.g. *Maines v. CIR*, 114 T.C. No. 8 (2015).

<sup>15</sup> Rev. Rul. 72-132, 1972-1 C.B. 21.

<sup>16</sup> See I.R.S. Tech. Adv. Mem. 79-50-002 (Aug. 2, 1979).

<sup>17</sup> I.R.S. Priv. Ltr. Rul. 80-38-037 (Jun. 24, 1980).

Alas, the IRS subsequently reversed course in a 1982 General Counsel Memorandum<sup>18</sup> which dealt with governmental grant to a public utility partnerships for the purpose of expanding the partnership's sewer facilities to serve a new housing project. The IRS held for the first time that section 118 only applied to a corporation. In 1990 the IRS issued a Technical Advice Memorandum<sup>19</sup> which held that a public utility partnership could not exclude from income under section 118 amounts received as contributions to expand services. The TAM revoked the 1979 TAM.<sup>20</sup> In 2011, the IRS issued in Appeals Settlement Guideline which holds at length that section 118 does not exclude grants from taxable income for non-corporate entities.

Accordingly, the rules are (or were) different for partnerships and LLCs taxed as partnerships than corporations. As stated above, at the time IRC 118 was enacted virtually all larger businesses were corporations and LLCs did not exist. Now even very large businesses are organized as LLCs and the majority of new business entities are set up as LLCs.

The IRS has subsequently issued several Policy Documents on the subject. In *IRS Industry Directive #3 of Section 118 Abuse* the IRS states:

Neither Code Section 118 nor any alleged common law "contribution to capital" doctrine permits the exclusion from income of amounts transferred to a non-corporate entity by a non-owner. The legislative history to Code Section 118 is clear that the provision codified the preexisting case law, all of which case law addressed the issue of whether amounts transferred to a corporation by a non-shareholder were excludable from income. Thus, neither the preexisting case law nor the Code supports the argument that amounts transferred to a non-corporate entity by a non-owner are excludable from income.

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<sup>18</sup> I.R.S. Gen. Couns. Mem. 38,944 (Dec. 27, 1982).

<sup>19</sup> I.R.S. Tech. Adv. Mem. 90-32-001 (Aug. 10, 1990).

<sup>20</sup> I.R.S. Tech. Adv. Mem. 79-50-002 (Aug. 2, 1979).

And, of course, under the new Tax Cuts and Jobs Act, section 118 no longer shields grants and other incentives to corporations from taxation. In addition, the Conference Committee report states, "The conferees intend that section 118, as modified, continue to apply only to corporations."

#### **B. Exclusion of Government Transfers**

If a particular grant is considered income there are several possible uncodified exclusions for partnerships and LLCs, (and now corporations).

The IRS has long recognized an uncodified exclusion from gross income in cases where a governmental authority grants a valuable, transferable right to one or more taxpayers. In Revenue Rule 67-135, the IRS ruled that a taxpayer who won a Bureau of Land Management drawing entitling him to lease oil and gas rights from the government at below fair rental value realized no income within the meaning of section 61. In Revenue Rule 92-16, the receipt of emission allowances under an EPA-sponsored program did not cause a utility to realize gross income. These rulings were cited in PLR 9851046 (Sept. 22, 1988) as supporting the nonrealization as income of revenues attributable to customer charges for transition costs under a state utility deregulation scheme.

#### **C. General Welfare Exclusion**

There is an uncodified<sup>21</sup> "general welfare" exclusion from gross income that extends to many types of government grants to individuals, usually outside of the business context. The "general welfare" exclusion covers most subsidy payments to the poor, replacement housing payments, payment under the Disaster Relief Act and flood relocation payments.

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<sup>21</sup> Congress, in response to 9/11, enacted new §139 of the Code.



In Revenue Rule 77-77, the IRS ruled that grants are made to Indian tribes by the federal government, for the purpose of expanding Indian-owned businesses, were excluded from tribal income under the general welfare doctrine. PLR 199924026 (March 19, 1999) addressed the taxability of economic development grants made by a tribal nation itself to individual tribal members. The program, which was federally sanctioned, was designed to overcome the scarcity of credit available to tribal members who wanted to start up their own small businesses. Cash grants were made to individuals and their businesses.

In the vast majority of IRS Policy documents which recognize the general welfare doctrine, however, the grants were made to individuals, and not businesses.

A grant to a limited partnership by a city for construction of residential rental units, residential units for sale, a hotel, parking, facilities, and recreational and shopping facilities on vacant land was held not to qualify for the general welfare exclusion from gross income because it was made to a business and not an individual. This grant was ineligible for the general welfare exclusion from gross income even though it was made for the purpose of obtaining an advantage for the general community that would not have been feasible without substantial financial support from public funds.<sup>22</sup>

Rev. Rul. #2005-46 dealt with the taxation of disaster relief grants for businesses. An area within state ST (New York) was affected by a disaster (9/11). To aid in the recovery of the area affected by the disaster, New York enacted emergency legislation appropriating funds for grants to reimburse uncompensated losses that any qualifying business incurred due to damage to, or destruction of, real property and other tangible assets, on account of the disaster.

The grants were available only if the qualifying business agreed to continue its operations for a minimum of 5 years in or near the area in New York affected by the disaster.

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<sup>22</sup> IRS PLR 80-38-037 (1980)

Reimbursement of eligible losses was limited to the fair market value of the property just before the time of the loss and is reduced by any other reimbursement that the qualifying business received to compensate for the property losses.

At issue in the Revenue Ruling was whether the grants were excludable from income under either the general welfare doctrine or as a contribution to capital under section 118.

Regarding the General Welfare exclusion, the Ruling states:

The Internal Revenue Service has consistently concluded that payments to individuals by governmental units under legislatively provided social benefit programs for the promotion of the general welfare are not included in a recipient's gross income ("general welfare exclusion"). To qualify under the general welfare exclusion, payments must (i) be made from a governmental fund, (ii) be for the promotion of the general welfare (i.e. generally based on individual or family needs), and (iii) not represent compensation for services. Payments to businesses generally do not qualify under the general welfare exclusion because the payments are not based on individual or family needs.

The Rev. Rul. Concluded:

X may not exclude ST's \$90,000 grant payment from gross income under the general welfare exclusion, because that exclusion is limited to individuals who receive governmental payments to help with their individual needs (e.g., housing, education, and basic sustenance expenses).

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X may not exclude the \$90,000 grant payment from gross income under § 118. The ST grant program compensates qualifying businesses for uncompensated eligible losses they incurred as a result of the disaster. Accordingly, these payments are more akin to insurance payments received for losses than contributions to capital of a corporation within the definition of § 118 and the case law.

In *Maines v. CIR*<sup>23</sup>, the Tax Court rejected the taxpayer's argument that refunds of certain state tax credits were excluded by the Welfare doctrine. The Tax Court noted that, "To qualify for the general-welfare exclusion, a payment must (1) be made from government funds; (2) to promote the general welfare (generally based on need); and (3) not be compensation for services." The Tax Court stated, "Grants from welfare programs that don't require recipients to show need have not qualified for the general-welfare exclusion." The United States Federal Claims ruled to the same effect regarding the refund of New York Brownfield Redevelopment Tax Credits in *Ginsburg v. U.S.*<sup>24</sup>

#### **D. Lack of Dominion and Control**

Another judicial doctrine which can result in a taxpayer not realizing income from grant funds is the dominion and control doctrine. Gross income is an undeniable accession to wealth, clearly realized, over which a taxpayer has *complete dominion*.<sup>25</sup> This maybe particularly appropriate for Developers who work with TIFs.

In *Commissioner v. Indianapolis Power & Light*,<sup>26</sup> the IRS argued that deposits which some 5% of customers were required to make to an electric utility were in essence advance payments for electric service and were therefore taxable in the year of receipt. Customer deposits were not physically segregated from general funds and were subject to the utilities unfettered use and control. The Supreme Court disagreed with the IRS, holding that the utility hardly enjoyed "complete dominion" over customer deposits and had an obligation to repay the money either when service was terminated or at the time the customer established good credit, both of which were largely in the control of the customer. The Court held that a taxpayer does

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<sup>23</sup> 144T.C. No. 8 (2015)

<sup>24</sup> F.Cl. (2018). See *Woolever, Tax Increment Financing, Governmental Grants and Developer Tax Consequences*, 40 Urb. Law 299 (2008); Crane, *Government Transfer Payments*, 59 SMU L.Rev. 589 (2006)

<sup>25</sup> *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955).

<sup>26</sup> *C.I.R. v. Indianapolis Power & Light Co.*, 493 U.S. 203 (1990).

not have dominion and control over a given sum unless he has some guarantee that he will be allowed to keep the money and, in making this determination, the crucial point is not whether the use of the funds was unconstrained during some interim period.

In *Lykes Bros. Steamship Co. v. Commissioner*,<sup>27</sup> a taxpayer operated a steamship belonging to the US Government to carry mail. The route proved unprofitable and consequently the government gave the steamship line a grant for the purpose of acquiring new ships and reconditioning old ones. The Fifth Circuit held that the grant was not required to be deposited in a special account and the taxpayer could have used the money any way he wished, and thus the grant was included in gross income, and was not a contribution to capital. The taxpayer did deposit the money in a special account, “[b]ut since no contract required it, no legal consequences follow.”<sup>28</sup>

In *Baboquivari Cattle Co. v. Commissioner*<sup>29</sup>, a rancher made improvements to its acreage and was awarded soil conservation grant funds which required compliance with government regulations for land use. The Ninth Circuit held the rancher exercised dominion and control over the grant because no portion of it was required to be placed in a particular account or fund; the payments were not earmarked and there was no restriction on the use of the funds. Petitioner was free to use the money for any purpose it might see fit, as to defray operating expenses or to pay dividends or to purchase an automobile.<sup>30</sup> Therefore the funds were includable in gross income.

By contrast in *Bailey v. Commissioner*<sup>31</sup>, the Tax Court held that the taxpayer did not

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<sup>27</sup> *Lykes Bros. S.S. Co. v. C.I.R.*, 126 F.2d 725 (1942).

<sup>28</sup> 26F.2d at 727.1

<sup>29</sup> *Baboquivari Cattle Co. v. C.I.R.*, 135 F.2d 114 (9<sup>th</sup> Cir. 1943), (cited as still binding precedent in *Berglund v. Commissioner*, 70 T.C.M. 1274 (1995).

<sup>30</sup> 135F.2d at 116.1

<sup>31</sup> *Bailey v. C.I.R.*, 88 T.C. No. 72 (1987).

have gross income on grants given by Pittsburg's Urban Redevelopment Authority (URA). The government grant program was designed to provide façade rehabilitation for buildings located in an historic district. As a condition of the grant, the taxpayer covenanted to make certain improvements and not to make other improvements without the consent of URA. The Court held that the grants were not taxable because the taxpayer did not have control of the rehabilitation work done on his façade and all of the rehab payments were made by VRA to a contractor and none were made payable to the taxpayer. In addition, the URA was the party that selected the contractor, negotiated the terms of the contract and paid for the work performed. The Court noted that unlike in prior cases, the taxpayer did not have complete dominion and control over the project and that, "the taxpayer's unfettered use of the funds received was an important factor in determining that they were includable income." While holding the grant funds were not taxable, the Court ruled against the taxpayer in several regards, finding that since the amount of the façade grant was not includable in income the work done with the grant funds could not be depreciated. The taxpayer had also argued the general welfare doctrine. The Court ruled that this doctrine was not applicable as the façade grants were awarded without regard to any financial needs of the recipients.

When a taxpayer can demonstrate that it is essentially acting as an agent for the government and the relevant public benefits from the expenditures it is allowed an exclusion from gross income. As in *Bailey*, the taxpayer's lack of dominion and control over the unfettered funds will be determining factor for the whether the income becomes includable.

The lack of dominion and control doctrine will rear its head in a large way under the new law, particularly for corporations that receive grants. A grant in South Carolina is awarded by the South Carolina Coordinating Council for Economic Development (the "Coordinating

Council") to local governments, which in most cases is the local county. Many grants are earmarked for purely public infrastructure such as road, water and sewer improvements, and in those cases, the county generally arranges for these infrastructure improvements to be made. Following *Bailey v. Commissioner*, a manufacturer which is the beneficiary of a public infrastructure grant typically does not have dominion and control over the funds. The manufacturer rarely has control over the public infrastructure work, and all of the infrastructure payments are made payable to contractors and not the manufacturer. In addition, the county is typically the party that selects the subcontractor, negotiates the contract and pays for the work performed.

Some grants do include brick and mortar improvements directly on private property. In most, if not all cases, the Grant contains a clawback provision. For an accrual base taxpayer, is the grant income realized (and the statute of limitations starts running) when (1) the grant is awarded, (2) the grant is accepted by all parties signing the grant documents; (3) the funds are disbursed (which is frequently done in stages); or (4) the grantee performs all its obligations under the grant (typically making certain minimum capital expenditures and hiring, and often maintaining, a minimum number of employees) and the clawback has burned off?

It is likely that the parties will now pay closer attention to the Grant documents and will work to minimize the federal income tax consequences. This is particularly so where a grant provides funds for both public infrastructure as well as free land or brick and mortar.

#### **E. Return of Capital**

Mertens *Law of Federal Income Taxation*<sup>32</sup> states with regards to *Edwards v. Cuba Railroad Co.*, *supra*, that "The Supreme Court held that subsidy payments made by the Republic of Cuba to a railroad company for the construction and maintenance of a railroad company for

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<sup>32</sup> 10 Mertens Law of Fed. Income Tax'n § 38:2

the construction and maintenance of a railroad were reimbursements for capital expenditures and not income within the meaning of the Sixteenth Amendment. The court emphasized the fact there was no attempt to tax property received, as distinguished from the cash subsidies, and made a point of the fact that money subsidies were not to be used for the payment of dividends, interest, or anything else properly chargeable to or payable out of earnings or income."

The taxpayers in several cases have argued the return of capital exception, principally under *S. Pac. Co. v. Lowe*, 247 U.S. 330 (1918). Under this doctrine, the repayment of an initial investment or outlay is nontaxable. Many taxpayers have treated state tax credit refunds as a return of capital. In *Maines v. CIR*, *supra*, the Tax Court held that the refund of New York state income tax credits were not a return of capital as the taxpayers paid no state income taxes (which had been eliminated by a portion of the state tax credits.) They did pay property taxes (through their LLC) which were refunded by a third New York credit "but they also benefited by deducting these payments (through [their LLC]). This means the credits can't be a *tax-free* return of capital."

In *Ginsley v. U.S.*, *supra*, the Court of Federal Claims held that the refund of New York Brownsfield Remediation state tax credits was not covered by the return of capital exception as the "Recovery of capital doctrine is limited to sales of goods."

#### **IV. "Refundable" Credits**

"Receipt of tax deductions or credits that just reduce the amount of tax a taxpayer would otherwise owe is not itself a taxable event, 'for the investor has received no money or other "income" within the meaning of the Internal Revenue Code.'"<sup>33</sup> By contrast, a taxpayer receives money in a refundable credit.

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<sup>33</sup> *Maines v. CIR*, 144TC No. 8 (2015) quoting *Randall v. Loftsgaarden*, 478 U.S. 647, 657 (1986).

With several exceptions, South Carolina's tax credits are nonrefundable, meaning that they offset state income tax liability, but are not allowed in excess of the taxpayer's liability. Refundable credits are those that are allowed even if they exceed the taxpayer's liability.

South Carolina has several refundable credits, including the tuition tax credit, a gas tax credit, the special needs tuition credit, the agricultural use of anhydrous ammonia credit, and the milk producers credit. None of the traditional South Carolina economic development incentives credits, however, e.g. Jobs Tax Credit, Investment Tax Credit, Abandoned Buildings Credit, are refundable.

The IRS first addressed refundable credits in an Office of Chief Counsel Memorandum dated November 26, 2008, which addressed two Michigan Economic Growth Authority (MEGA) credits: the Business Activity Credit and the Employment Credit. The Business Activity Credit allows a 100% credit of Michigan's Single Business Tax, capped at the tax due to the state. The Employment Credit, on the other hand, was refundable to the extent it exceeded a corporation's Single Business Tax liability for a given year. The IRS characterized the Business Activity Credit as a mere reduction in tax liability, not subject to gross income inclusion, consistent with its above-mentioned CIP.

However, the IRS recognized the potential for gross income in Michigan's refundable Employment Credit. Refundability, according to the IRS, is a narrow term limited to situations in which unused credits may be returned to the governmental entity in exchange for a cash payment above and beyond the actual tax due. Therefore, excess credit paid back to a corporation above and beyond its tax liability will be treated as gross income.



In March 2015, the United States Tax Court held in *Maines v. CIR*<sup>34</sup> that particular refundable tax credits associated with economic development activities are subject to federal income taxes. The state of New York gave the taxpayers targeted economic development tax credits (EZ Investment credits, EZ Wage credits and QEZE Real Property Tax credits) in exchange for the taxpayer's continued investment in specific areas of the state. The QEZE Real Property Tax credit limited the refund to actual taxes paid, while the EZ Investment credit and the EZ Wage credit were not limited to actual taxes paid. The Tax Court saw the EZ Investment credit and the EZ Wage credits not as direct subsidies that are taxable accessions to wealth. The court further held that EZ tax credits that only reduce tax liability are not federally taxable, but EZ tax credits that operate as refundable overpayments are taxable accessions to wealth.

With regard to the real property tax credit, the LLC paid and deducted real property taxes and consequently reported less income to the LLC members, including the Maines on their K-1. The decreased amount of pass-through income led to a smaller taxable income to the Maines. The Tax Court held that under the Tax Benefit Rule any refundable portion of the Real Property Tax Credit that remained after first reducing the Maines's state income tax liability was taxable as income. The Court held that it was of no consequence that the LLC paid and deducted the real property taxes while it was the Maines's who received the refundable credit.

## **V. Transferable Credits**

South Carolina has only one unlimited transferable credit, the Conservation Tax Credit. Several other tax credits, including abandoned Building and Textile Revitalization tax credits can be transferred to the purchaser or tenant of an eligible project.

Traditionally, states have used transferable tax credits for entertainment, energy, and real estate developments. When the amount of credits exceeds a business's liability, transferable tax

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<sup>34</sup> 144 T.C. No. 8 (Tax Court 2015).

credits allow the business to sell the excess. Sometimes states even refund the excess transferable tax credits to businesses. This process is sometimes done through tax credit brokers. The transfer allows business to gain capital value from the excess credits. This type of system is a recruitment tool in economic development deals that helps states attract larger businesses and deals.

However, transferable credits may be subject to taxation.<sup>35</sup> The IRS considers some sales of tax credits as taxable events due to the recipient's gain on the sale of the credit, especially if purchased for less than the face value.<sup>36</sup> Furthermore, the IRS considers the original recipient's gain on the sale a capital gain, unless the credit falls into a statutory exclusion under § 1221(a). The United States Tax Court held in *McNeil v. Commissioner* that transferring tax credits are a gain of value and therefore are taxable<sup>37</sup>. Businesses are now obligated to report their sale of transferable tax credits as a capital gain because of the transactional nature.<sup>38</sup>

In *George H. Tempel v. Commissioner*<sup>39</sup> the taxpayers sold \$110,000 of unused state conservation easement credits for \$82,500. They reported a short-term capital gain of \$77,603 after deducting a portion of the expenses resulting from the easement donation. The IRS argued that the gain should be treated as ordinary income. The Tax Court agreed with the taxpayer regarding the short-term capital gain. The sale resulted in a short-term capital gain but the Court disallowed the deduction as outlays unrelated to the credit.

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<sup>35</sup> See generally, Feld, *Federal Taxation of State Tax Credits*, 151 TaxNotes 1243 (2016).

<sup>36</sup> I.R.S. Gen. Couns. Mem., 201147024 (Sept. 15, 2011).

<sup>37</sup> *McNeil v. CIR*, 101 T.C.M. (CCH) 1535, (T.C. Memo. 2011-109.)

<sup>38</sup> *Id.*

<sup>39</sup> 136 T.C. 341 (2011)

The IRS Chief Counsel Advice<sup>40</sup> has held that a transferable state tax credit that does not fall into one of the statutory exclusions constitutes a capital asset. An earlier Advice stated that the sale of a Missouri remediation tax credit resulted in ordinary income.<sup>41</sup>

## **VI. South Carolina State Tax Incentives**

According to the IRS,<sup>42</sup> "A SALT or similar tax incentive [exclusive of refundable or transferable] credits: (1) is not income under I.R.C. §61, (2) is not a contribution of capital under I.R.C. §118(a), and (3) therefore does not reduce a corporation's basis under I.R.C. §362(c). This is because these tax incentives, whether in the form of an abatement, credit, deduction, rate reduction or exemption, simply reduce the tax imposed by state or local governments."<sup>43</sup>

### **A. South Carolina's Job Development Credit**

The Job Development Credit is one of South Carolina's best economic development incentives as it is a withholding ---and not an income--- tax credit. It is a discretionary incentive that allows business approved by the Coordinating Council to obtain a rebate of a portion of state withholding taxes paid to reimburse a the business for eligible expenditures, typically, the cost of acquiring or improving real property.

The South Carolina's Job Development credit should not have federal income tax ramifications. A qualifying business may only claim an amount equal to or less than the withholding tax paid to the State. Rebates under the statute, therefore, are capped at the withholding tax paid by the businesses. Although the businesses will receive a quarterly "refund" from the state after qualifying under the statute, this credit is not "refundable" according to the IRS definition, because the credit may only be refunded to the extent of the tax

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<sup>40</sup> CCA 201147024

<sup>41</sup> CCA 200122042

<sup>42</sup> IRS ATG on State, Local Tax Incentives under Section 118 (March 7, 2011)

<sup>43</sup> IRS ATG on State, Local Location Tax Incentives Under Section 118.

owed. The Chief Counsel Memorandum<sup>44</sup> states: “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 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 income unless some exclusion applies.” Therefore, the value of the credits received should not be subject to gross income inclusion.

### **B. Export Tax Credits**

South Carolina provides a tax credit to a taxpayer engaged in manufacturing, warehousing, freight forwarding, freight handling, or wholesaling of goods or distribution that uses South Carolina port facilities and increases its port cargo volume at these facilities by at least 5% in a calendar year over its base year port cargo volume. The credit may be claimed against income taxes or employee withholding taxes.

The amount of credit and the type of taxes the credit may offset is determined by the Coordinating Council for Economic Development. Any unused income tax credit may be carried forward for 5 years and unused withholding tax credits may be carried forward for 20 quarters. The Port Cargo credit is not refundable, and similar to Job Development credits, should have no federal income tax consequences.

### **C. Film**

South Carolina provides an income tax credit equal to 20% of a taxpayer’s cash investment in a company that develops or produces a qualified South Carolina motion picture project. South Carolina also provides an income tax credit equal to 20% of the taxpayer’s investment in a company that constructs, converts, or equips a motion picture production facility

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<sup>44</sup> I.R.S. Gen. Couns. Mem. (March 4, 2010).

or post production facility in South Carolina. This credit is also not refundable, and should have no federal income tax implications for either corporations or LLCs. This credit, when combined with all the taxpayer's other South Carolina income tax credits, cannot exceed 50% of the taxpayer's South Carolina income tax liability. Any unused credit can be carried forward for 15 years. These credits are non-refundable and have no federal tax consequences.

South Carolina also allows certain payroll expenses and expenditures incurred in connection with filming a motion picture in South Carolina to be rebated to a motion picture production company. The wage rebate cannot exceed 20% of the total aggregate South Carolina payroll of the persons employed in connection with the production of a motion picture in South Carolina and 25% for South Carolina residents employed in connection with the motion picture. The Film Commission may also rebate to a qualifying motion picture production company up to 30% of its expenditures made in South Carolina on a motion picture production. These rebates are the most problematic of all the state incentives for both corporations and LLCs.<sup>45</sup>

#### **D. Property Taxes**

The major property tax incentives are fee-in-lieu, Multi-County Industrial Park Special Source Revenue Credit, and the manufacturer's abatement. These incentives simply lower the property taxes which would otherwise be paid by the property tax owner, and are not refundable. For the reasons stated above, they (the property tax savings) would almost certainly *not* be considered taxable income to either corporations or LLCs. Indeed, the Conference Committee report quoted *supra* noted that "By contrast [to a gift of land by a municipality], a municipal tax abatement for locating a business in a particular municipality is not considered a contribution to capital."

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<sup>45</sup> See generally, M. Salama, *State Film Tax Incentives and the Related Potpourri of Federal Income Tax and Accounting Considerations*, 62 Tax Lawyer 1085 (2009).

### **E. Sales Taxes**

South Carolina has a host of sales tax exemptions, particularly for manufacturers. These include exemptions for machinery and equipment, research and development, electricity, pollution control, material handling equipment and the like. Again, these exemptions are not refundable and almost certainly are *not* considered taxable income.

### **F. Income Taxes**

South Carolina has a 100% sales factor formula for many multi-state taxpayers, and manufacturers and some service providers only pay state income taxes on income earned from sales to South Carolina customers. In addition, the state has a host of income tax incentives, including Jobs Tax Credit, Research and Development Tax Credit, and an Investment Tax Credit, among many others. None of these incentives are refundable. Again for the reasons stated above, these incentives are almost certainly not considered taxable income to any form of business entity.

### **G. Governmental Grants**

South Carolina and a few counties have governmental grant programs. The state grant programs include the Economic Development Set-Aside Funds, the Rural Infrastructure Funds and the Governor's Closing Fund. These grant funds from the State Department of Commerce are in the form of a check made payable to the county for public (road, water & sewer) infrastructure improvements. In this scenario the grants would likely not be considered taxable income, even if a private entity locating in the County was the prime beneficiary of the grant.

On some occasions, however, a grant program may benefit the economic development prospect directly, for example reimbursing the cost of site prep or bricks & mortar. This presents a tougher case if the company has dominion and control over the funds.

## H. TIF

"In the typical TIF redevelopment plan, the developer chosen by the governmental body to implement the plan receives substantial grants of money or property...from...the local government body....This governmental grant may constitute income to the developer according to the broad definition of gross income under Code section 61 unless there is either a specific exception provided in the Code or the governmental grant meets a case law exception. Because these grants are often in the millions of dollars, if the developer is forced to recognize gross income, the proposed redevelopment plan may fail. Indeed, even the most well thought out TIF redevelopment plan may fail because a potentially sizeable federal tax liability could cause the deal to become a financial loser for the developer unless the city is willing to alter the redevelopment plan in some creative way to help cover the developer's unexpected tax bill."<sup>46</sup>

The South Carolina General Assembly enacted the Tax Increment Financing Law "to establish authorization for municipalities to incur indebtedness to revitalize blighted and deteriorating areas within the municipalities."<sup>47</sup> The TIF law authorizes cities or counties to issue TIF bonds to finance a redevelopment project within a redevelopment project area. A redevelopment project generally includes public infrastructure, including buildings, street, road, highway water, sewer, parking and public transportation, including rail. In addition, redevelopment projects include publically owned affordable housing and may be used to provide infrastructure projects to support privately owned affordable housing.

Eligible redevelopment project costs include architectural, engineering, legal or financial planning, property assembly costs, costs of rehabilitation, reconstruction or repair and the costs of construction and long-term maintenance of a redevelopment project.

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<sup>46</sup> Woodlever, *Tax Increment Financing, Government Grants and Developer Tax Consequences*, 40 Urb Law 299 (2008).

<sup>47</sup> *Wolper v. City Council of the City of Charleston*, 278 S.C. 209, 336 S.E.2d 871 (1985).

Prior to the issuance of TIF bonds the City or County must adopt a redevelopment plan which describes the plan to reduce or eliminate the conditions giving rise to the TIF district (e.g. agricultural, blighted, conservation or sprawl area). The plan must include estimated redevelopment costs and the anticipated sources of funds to pay the costs.

Some city or county TIFs are purely the creation of city or county council and some are developer driven. In the latter case, a real estate developer is typically instrumental in drafting the Redevelopment Plan.

In many cases, the city or county establishes and funds the TIF and does the redevelopment without private sector involvement. On occasion, the private real estate developer will obtain variances from the state DOT, City or County, and hire and pay the contractors to build purely public infrastructure benefiting his real estate development, and will be reimbursed from TIF funds.

Where the developer receives grant funds from the city or county, it raises the specter that the IRS will view the grant as taxable.

Thus, in order to satisfy the dominion and control exclusion from gross income under the *Bailey* approach, a developer must demonstrate that its use of the governmental grant is contractually restricted in some way essentially causing the developer to act as an agent of the governmental body. The developer will need to show that the public, not the developer, will receive the direct advantages of the development. Finally, as *Lykes Bros. Steamship Co.* demonstrated, the Service will look to the substance of the transaction and not the form when determining whether the developer has dominion and control over the grant. Therefore, just because the developer keeps the grant in a separate account or uses it for a special purpose will not itself be enough unless this special account or special purpose use was contractually required. If a governmental grant of money is used by the developer to pay operating expenses associated with a TIF redevelopment project, then the grant may qualify for the dominion and control exclusion from gross income as long as the developer is contractually required to use the grant only for certain authorized



operating expenses carrying out the instructions of the governmental grantor without discretion on the part of the developer to determine when or how the grant will be used.<sup>48</sup>

The effective date provision in the new bill does have a grandfather provision which will likely apply to some TIFs. It states, "the provision shall not apply to any contribution made after the date of enactment by a governmental entity pursuant to a master development plan that has been approved prior to such date by a governmental entity." A TIF Redevelopment Plan is likely a "master development plan."

TIFs typically last years and many last decades. The original Redevelopment Plan enacted in e.g., 2012 may not encompass improvements to made in 2019 for the benefit of a private real estate development. Redevelopment Plans are frequently amended for this purpose.

Presumably, a Redevelopment Plan under the SC TIF statute is a "Master development plan" under the Tax Cuts and Jobs Act. Is a Redevelopment Plan enacted by a city in 2012 and amended in 2018 still under the grandfather provision?

If so, could a city amend a pre-December 22, 2017 Redevelopment Plan to include completely new (and non-contiguous) real estate developments for purposes of coming under the grandfather provision?

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<sup>48</sup> *Tax Increment Financing, supra.*

Burnet R. Maybank is a Member of Nexsen Pruet and a former two-time Director of the South Carolina Department of Revenue; Lindsay Richardson and Sam Johnson are most excellent law clerks.