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FEDERAL COURT RULES REFUNDED NYS BROWNFIELD TAX CREDITS ARE TAXABLE FEDERALLY

Hodgson Russ Environmental Alert
May 7, 2019

New York's Brownfield Cleanup Program ("BCP") is one of the more effective tax-based incentive programs offered by the state. The BCP allows participants to remediate a contaminated piece of real property in exchange for tax credits that can total up to 50% of the qualified remediation costs incurred to clean the property, and 24% of the qualified construction costs incurred to develop the property after it has been remediated. These tax credits can be the difference between a lucrative development and one that is economically unfeasible.

Unfortunately, a recent decision by the Federal Circuit Court of Appeals diminishes the economic benefit of the tax credits because it concludes that the refundable portion of the tax credits (i.e., the portion that was not used to offset the taxpayer's tax liability) qualifies as taxable income for federal income tax purposes. In other words, some participants in the BCP will have to pay federal tax on some or all of their state tax credits. Below is a review of the case.

In *Ginsburg v. United States*, the individual taxpayers indirectly owned an interest in an LLC that acquired a contaminated piece of real property that was admitted to New York's BCP. Over the course of seven years, the taxpayers, through the LLC, cleaned the property of contamination and converted what was once an old shoe factory into a residential rental building in Brooklyn, New York. The LLC submitted an application for the resulting tax credits totaling $6,583,835, of which $4,975,595 was claimed by the taxpayers. After using a portion of the tax credits to offset their New York tax liability, New York State issued the taxpayers a refund check totaling $1,903,951. After accounting for state tax withholdings and estimated state tax payments, auditors for the IRS concluded that the taxpayers owed $602,530 in federal tax on the refunded tax credits. The taxpayers paid the asserted federal tax liability, but filed a refund claim contesting that the refunded credits qualified as taxable income federally. The IRS effectively denied the claim and the taxpayers initiated their appeal.

After initially losing in the Federal Court of Claims, the taxpayers appealed to the Court of Appeals for the Federal Circuit. The Court of Appeals concluded that the excess amount of the tax credits received by the taxpayers qualified as "taxable gross

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income because it is an undeniable accession to wealth over which the [taxpayers] have complete dominion and control." The Court rejected the taxpayers' argument that the refunded credits were a return of capital as "'reimbursement of a portion of the capital costs,' i.e., costs relating to investments made by them for the cleanup and redevelopment of the property" because the underlying costs giving rise to the credits were not paid to New York (they were paid to the contractors doing the remediation and construction at the site) and the taxpayers failed to explain why the payment of the excess amount of the credits constitutes a return of their basis to restore impaired capital (it was the LLC, not the individual taxpayers receiving credits, that invested in the Brownfield site according to the Court).

The Court also concluded that the taxpayers had "complete dominion and control of the tax credits" because there were no conditions on how they could spend the refunded amounts, and the BCP's tax credit recapture provisions were within the taxpayers' control. This reasoning seems a bit incongruous because in one breath the Court claims it was the LLC that made the investments to clean and develop the property, but in another, it says the individual taxpayers were in a position to control whether the BCP's recapture provisions would be implicated. And what about minority investors in a BCP project? They may not be in a position to direct the operations of the entity conducting the cleanup and development. Is this restriction enough to demonstrate that a taxpayer does not have "complete dominion and control of the tax credits?" Perhaps this is a fight for another day.

This decision comes at a particularly tough time for New Yorkers vis-à-vis their federal tax obligations. Much has been written on the disparate impact the Tax Cuts and Jobs Act ("TCJA") has on "high-tax" states (i.e., New York, New Jersey, California) as a result of its limitation on the state and local tax deduction. Moreover, the TCJA also amended section 118 (a) of the Internal Revenue Code by eliminating the exclusion for nonshareholder contributions to capital. Prior to the TCJA, this provision allowed corporations to claim that the refunded portion of state tax credits they received constituted capital contributions, excludable from the corporation's gross income. Thus, between this new Court of Appeals ruling and the TCJA, it appears that both individuals and corporations may have to treat refunded tax credits as taxable income federally.

So while the BCP remains one of New York's most lucrative tax-based incentive programs, participants should not forget to factor in the federal tax impact of any refunded credits.

Please contact Joseph N. Endres at either jendres@hodgsonruss.com or 716.84.1504 if you have any questions regarding the content of this alert. If you received this alert from a third party or from visiting our website, and would like to be added to our Environmental Law mailing list or any other of our mailing lists, please visit us at: https://forms.hodgsonruss.net/sign-up-for-email-and-other-communications..html.