MISSOURI TAX CREDIT REVIEW COMMISSION

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Memorandum

TO: **Senator Chuck Gross**

FROM: **Tax Law Committee:**
Steven Stogel, Chair
Penny Rector
Russ Still
Ray Wagner

CC: **Chris Peiper**

DATE: **November 15, 2010**

RE: **Supplemental Tax Law Committee Report**

1. The Tax Law Committee was asked on October 27, 2010 to follow up on the proposed federal tax law changes on the Social Credits, AHAP and MDFB contribution credits (collectively, "Donation Credits").

It is noted that Donation Credits have an embedded up to 35% federal tax cost for non-AMT taxpayers.

There is, in fact, a 2003 IRS Private Letter Ruling #200348002 which has been issued that ruled if a state transferable certificate were applied to a state tax liability, even if "tax liability" is "reduced" for state law purposes, the application of a Donation Credit can be treated as a cash "payment" for federal income tax purposes of "state taxes paid". Hence, a full Section 164 deduction is possible. See the revised recommendation #1 in Exhibit 1 attached.

It is recommended that the State now apply for a Revenue Ruling on this point for all Donation Credits, and, if granted, a legislative alternate is not then needed.

If such a Ruling were granted, either (a) the starting point of $1 could be reduced to 65 cents, or (b) the match now proposed of 35 cents, down from 50 cents, of credits to receive $1 dollar in donations could be reduce to 25 cents, improving the dollars raised.

2. Recommendation #2 in the new Exhibit 1 has broadened to include either an exclusion from income on the sale of transferable certificates or an accounting allocation of basis by the addition of a new Section 732(g).

3. The Tax Law Committee has continued its dialogue with the LIHTC Committee on a new idea, as detailed in the LIHTC Supplemental Report. That idea is to change the State law to allow already allocated LIHTCs to be converted at a discount amount from par to transferable certificates annually, and then to process those certificates through the new Plan # 3 DED entity to be grants to the project. This is in essence both a tax driven efficiency and a "buy-back" plan of the already issued LIHTCs, and may result in a substantial savings for the State.

Exhibit 1

TO: Tax Law Committee
Missouri Tax Credit Review Commission

FROM: Steven Stogel Chair, Tax Law Committee

DATE: October 12, 2010

SUBJECT: Federal Tax Law Changes

The eight states that border Missouri (Illinois, Kentucky, Tennessee, Arkansas, Oklahoma, Kansas, Nebraska and Iowa) all have distinct tax credit programs, totaling, for instance, 153 programs just for economic development. **These local programs all bear the burden of adding a Federal income tax to fiscal investment and use of tax credits.**

The Tax Law Committee of the Missouri Tax Credit Review Commission should recommend that the Federal Government eliminate this Federal income tax "cost" as part of a better national policy that allows each State to dedicate scarce resources in these difficult economic times to promote its own economy as local needs dictate, and to shift part of the budgetary responsibility to stimulate the economy from the Federal Government to the States.

Stated simply, state tax credits now carry up to a 35% Federal tax cost, depending on the format of the state credits and the tax bracket of the donor or investor. In these economic times, this cost can no longer be borne as an embedded cost. So, in order to preserve and maximize these valuable and critical resources for local stimulus programs, and given the declining available "stimulus" help from Washington, it is critical to have the States create capital investment incentives and job creation programs at the most efficient cost, specifically without an embedded Federal tax cost.

Accordingly, the Tax Law Committee should make two distinct recommendations to eliminate this "tax cost":

Recommendation #1: Amend Section 164(a) of the Internal Revenue Code ("Code ") to codify IRS Private Letter Ruling 200348002 in order to provide for a Federal tax deduction for the use of all purchased state tax credits.

Current Section 164(a) provides for a Federal income tax deduction for certain state and local taxes that are "paid or accrued" during the taxable year. However, under current law, a state tax credit is treated for Federal income tax purposes as a reduction in the taxpayer's state tax liability and not as a payment of that liability. Accordingly, the state tax credit reduces the amount that the taxpayer would otherwise be entitled to deduct under Section 164. The IRS has privately ruled that purchased state historic tax credits may be allowed as a deduction under Section 164 in Private Letter Ruling 200348002. But, a private letter ruling is not regarded as binding precedent and may only be relied upon by the taxpayer requesting the ruling for the type of transaction involved.

The Tax Law Committee should recommend amending Section 164(a) to provide that state taxes are "paid or accrued" for purposes of Section 164(a) to the extent the taxpayer transfers cash,

property or state tax credits to satisfy its state tax liability. The Federal tax effect of such an amendment would be to increase the deduction for state and local taxes paid because a state tax credit would be viewed as a payment, rather than a reduction, of state tax liability. It is noted that this change would affect only taxpayers not in AMT, as State income taxes are not deductible in the AMT calculus. This change would allow Missouri to either (i) increase the required contribution tax credit match to $3 of donation per $1 of tax credit, or (ii) maintain a $2 donation for 65 cents of tax credits.

Recommendation #2: Add either (i) a New Section 139D to the Code to provide that amounts realized from the sale of state tax credits are excluded from gross income or (ii) add a New Section 732(g) to the Code to provide for a partnership-level election to allocate tax basis to distributed state tax credits, provided that the partnership and the partner, receiving the state tax credits, make corresponding reductions in tax basis of other partnership assets and the partner's interest in the partnership under Section 733.

State tax credits are often certificated and also are transferable. So, a taxpayer may choose to transfer the credit to a third party for cash, rather than using the credit to reduce its own state tax liability. The sale of a state tax credit, under current law, results in the realization of Federal taxable gain by the transferor equal to the amount realized upon the sale. The Federal tax on the sale proceeds reduces the effective value of these investment credits.

If a new provision were added as Section 139D to the Code, it could provide that the proceeds from the sale of state tax credits are excluded from the gross income of the transferor. This change would allow Missouri to reduce the investment credit awarded to a business, real estate project or job training program by up to 35 cents and still maintain the full force and effect of this State economic incentive.

Another way to achieve the same result would be to add a Section 732(g) to the Code to allow for the project partnership, receiving state tax credits, to reallocate tax basis away from other partnership assets to the state tax credits that are being distributed to a partner. The partner receiving the distributed state tax credits would be required to decrease his or her tax basis in their partnership interest pursuant to Section 733. If a partnership and partner are permitted to make these tax basis adjustments, then the partner that is distributed the state tax credits will be able to sell the state tax credits without adverse tax consequences, as gain that would otherwise result may be offset by the amount of tax basis allocated to the state tax credits. If this alternative approach is taken, Section 732(g) will also need to state that reductions in tax basis of other assets at the partnership level will have no effect on any previous calculations of federal tax credits, such as the amount of "eligible basis" for purposes of determining the federal low-income housing credit under Section 42 of the Code or "qualified rehabilitation expenditures" under section 47 of the Code. Further, Section 732(g) will need to provide for a method of allocating tax basis away from other partnership assets to the state tax credits. For example, the reduction in tax basis could be allocated on a pro-rata basis and based upon the relative tax basis of each remaining asset compared to the total tax basis of all other remaining partnership assets. The federal statute could authorize the Treasury to establish other allocation rules and alternatives in Treasury Regulations.

Absent the adoption of these recommendations, or similarly effective Federal legislation, it is clear that Missouri faces a substantial redefinition and reduction of these programs, given Missouri's declining General Revenues. Missouri is like virtually all States in this regard at this time.

I note that these two Recommendations will need to go through the regular Congressional processes, including "scoring", but the impact to the Federal budget is minor when compared to the positive impact of allowing each State to utilize its own resources for job creation and increased capital investment, all of which are of incalculable value.

The Tax Law Committee should recommend seeking guidance on how to raise this to a National issue, so the requisite legislation might be enacted yet this year, so the economic power of these tax credits can be continued, and perhaps, increased, thereby benefiting both Missouri and other states, and the national economy.