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ACCOUNTING MATTERS

Business tax incentives

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Abstract Valued at $80 billion annually, state and local tax incentives are an important source of capital for expanding or relocating businesses. Using Tesla's recent $1.4 billion megadeal in Nevada as an example, we outline best practices for negotiating incentive packages. This installment of Accounting Matters discusses the evolution of incentives and provides insights regarding the regulatory and oversight changes that business owners and executives should anticipate. We conclude with recommendations for navigating increased compliance and reporting burdens.

1. Tesla's sweet deal

Elon Musk, PayPal founder and Tesla Motors' CEO, is often referred to as the Steve Jobs of the automotive industry. While that comparison is open to debate, there is no doubt the innovative car company's leader has mustered an impressive following. Whether they be car aficionados, environmentally friendly consumers, or investors looking for a sweet return, Musk has them all listening to his every word—and, in the case of Nevada, willing to provide a massive amount in state incentives to add Tesla to the governor's economic development trophy case.

Tesla has yet to make a profit, but the brand is sexy and a media favorite. This brand recognition, coupled with the promise of 6,500 jobs and billions in investment dollars, is what motivated states to answer when Tesla came knocking. In October 2013, Musk invited representatives from seven different states to Tesla's car factory in Fremont, California, to discuss plans to build a massive battery plant, or 'gigafactory.' Through a grueling, blind-bid process, Nevada landed the deal by offering nearly $1.4 billion in tax incentives encompassing free land, tax abatements, and electricity discounts (Elkind, 2014).

2. Incentive negotiation best practices

So how did Tesla go about securing such a substantial tax deal when the company is not yet profitable and sells only a fraction of the number of vehicles General Motors moves per year? The answer lies in the strategic process that Musk used, which is directly out of the incentive playbook (see Figure 1).

Tesla management began by determining what the company needed in a facility and shortlisted states based on a number of business factors including climate, location, and greenfield development opportunities. Musk then selected an even smaller

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Figure 1. Process to achieve business incentives*

*Source: Adapted from Exhibit 1 of Press (2009)

number of finalists—Nevada, Texas, Arizona, and New Mexico—and played each off the other; to prompt larger bids, a state would be told that it was hundreds of millions of dollars behind the leading contender. As the competition continued, Tesla increased its requests. For example, while Tesla initially sought 90 acres to develop, by the time its incentive package with Nevada was finalized, Tesla had secured nearly 1,000 acres of free land (Elkind, 2014).

Other incentive negotiation tactics include prioritizing the desired incentives and communicating a consistent message to the decision makers. Musk made it clear through public statements, including earnings calls, that completion time was priority number one in selecting the gigafactory location. Nevada gave Tesla a preview of construction speed when crews reportedly worked around the clock to level and grade hundreds of acres. Although low regulatory hurdles, right-to-work laws, and a location close to Tesla's California car factory favored their state, Nevada's leaders felt the need to demonstrate that Nevada was a get-things-done kind of state (Clifton, 2014).

Musk remained aggressive during negotiations—so aggressive, in fact, that no state was able to satisfy Tesla's request for $500 million cash. Instead, Nevada will provide $308 million in cash equivalents in the form of transferable tax credits and highway funds. Figure 2 lists the largest incentives and their estimated value. Nevada also agreed to pass a controversial law legalizing the direct sale of automobiles in the state, something even Texas refused to do (Elkind, 2014). In hindsight, it is easy to see that Nevada was the front-runner: it was closest to the California factory and Tesla broke ground in Reno months before the negotiation was over. However, Musk kept the pressure on by stating that several locations might be selected initially, and then leveraged competing states' offers while he focused his time and efforts on Nevada.

Advocates for business incentives (e.g., politicians, the business community) will pitch tax abatements as costless to the government: were it not for these projects, they argue, the taxes would not exist to give away. However, in the case of Nevada's incentives, the state's finances were affected: the highway funds and the tax credits both came directly out of the state's budget, which forced the Nevada legislature to make budget cuts elsewhere and rescind recently passed tax credit legislation for movie production.

Figure 2. Tesla's largest incentives

Incentives	Estimated Value in Millions ($)
20 Year Sales Tax Abatement	725.8
10 Year Property Tax Abatement	349.0
Transferable Tax Credits	195.0
Highway Funds	113.0
10 Year Payroll Tax Abatement	29.4
Discounted Electricity	8.0

While tea partiers and liberals do not agree on many tax policies, they do concur regarding business tax incentives. Libertarian groups and conservative organizations such as the Heritage Foundation are opposed to incentive deals and other forms of crony capitalism via which the government interferes with the market by picking winners and losers. Liberal groups dislike incentives because tax cuts lead to cuts in education, infrastructure, and other government programs.

Elon Musk overcame objections raised from all sides by again following best practices. He used media channels and extensive lobbying to convince decision makers that the economic impact of the Tesla facility would justify Nevada's investment. Promises of 6,500 direct jobs, 1,500 indirect jobs, and a \$5 billion investment were noted as the most compelling factors to justify the incentives. Governor Brian Sandoval stated to Nevada legislators that, with the Tesla deal: "We have changed the trajectory of Nevada forever" (Damon, O'Driscoll, Hagar, & Marcus, 2014). As part of the final agreement, Musk also agreed to givebacks (donations to education and hiring local workers) and clawbacks (refunds if employment projections are not met).

3. The evolution of business incentives

The first formalized government incentive program was established in Mississippi during the Great Depression. Spurred by declines in milling and agriculture throughout the 1920s, Columbia, Mississippi, searched out an industrial firm. Reliance Manufacturing Company was offered \$85,000 to build a shirt factory if it would create 300 jobs and invest in the local economy (Lester, 2004). This initiative, named the Balance Agriculture with Industry program, was considered a success, as the factory reached its employment goals within 4 years during the Depression.

Columbia's mayor was shortly thereafter elected state governor on an economic development platform. The entire nation was struggling, but Mississippi agriculture was particularly hard hit; in a single day in 1932, one-fourth of Mississippi's farmland was sold for back taxes (Lester, 2004). The Balance Agriculture with Industry plan was passed statewide—over objections from citizen groups and constitutional scholars, and despite a lawsuit—as part of the Mississippi Industrial Act of 1936. It formalized programs for localities to finance land purchases and plant construction with government bonds.

After World War II, the site-location consulting industry boomed as local and state governments strategically positioned themselves for growth. Consultants used their golden rolodexes to quietly play matchmaker between manufacturers looking to relocate to states with lower costs and right-to-work laws and those governments offering incentives. During the 1970s recession, more states turned to incentives to boost local economies. For example, Pennsylvania gave \$100 million in incentives for a Volkswagen Rabbit assembly plant that would employ 2,000 workers—a plant that was shuttered within a decade (Gazarik, 2013).

4. Race to the bottom

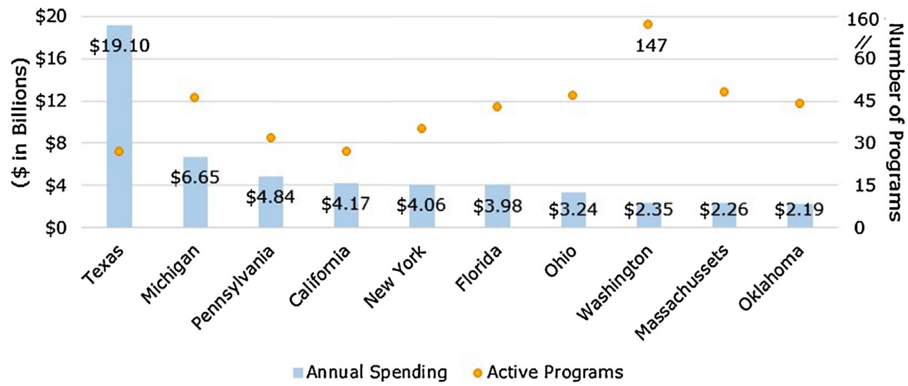
Politicians are enamored of megadeals due to the attendant splashy headlines promising jobs, economic development, and wins over neighboring states, which can later be touted during re-election campaigns. Megadeals are certainly more common today than they were in the past, and are clearly more lucrative: compare 1984, with only one deal over \$75 million, to 2012, with 21 deals averaging \$290 million each (Mattera, Tarczynska, & LeRoy, 2013). To put things in perspective, Tesla's \$1.4 billion package does not even make the top five deals to date. Washington State passed the largest extant incentive package: an \$8.2 billion deal to secure production of Boeing Company's new jetliner, on the heels of a \$3.2 billion package from the state to the company in 2004 (Forbes, 2014a). On the opposite coast, in 2007 Steelmaker Alcoa received a \$5.6 billion incentive package that included 30 years of discounted electricity from the State of New York (Forbes, 2014b).

While the megadeal figures are staggering, they represent a mere drop in the bucket of overall state incentive spending. Even business executives with modest expansion plans can apply to state agencies established to give incentives for economic development. A recent study found that 1,874 state and local incentive programs award \$80.4 billion annually (Story, Fehr, & Watkins, 2012). Incentive spending varies by state, from Texas, with \$19.1 billion, to South Dakota, with \$27.8 million in 2012. Figure 3 depicts the top 10 states as ranked by number of incentive programs and billions spent annually on incentive expenditures.

The type of incentives offered has also evolved. Businesses now receive cash and cash equivalents such as transferable credits and programs that allow them to keep their employees' payroll withholding taxes. As a result, bidding wars similar to those in the Tesla case are not uncommon.

The border war between Kansas and Missouri is a prime example of tax incentives gone astray.

Figure 3. Top 10 States by incentive expenditures and programs



Divided only by yellow paint on Stateline Road, the two Kansas Cities poach each other's businesses, creating net losses for both states. Each side gives away tax revenue, but unlike in the competition between Reno and Phoenix, the winning city sees no compensating uptick in population, individual income taxes, or property values. Missouri residents simply drive across the state line to work and then return to Missouri to live, shop, and dine each night. The Kansas-Missouri border war has provided very small firms millions in incentives to move, and larger firms need only threaten a move to receive grants.

To appreciate the scope and dedication of states to attracting business, one must look to Texas. In 2003, Governor Rick Perry established the Texas Enterprise Fund (TEF) to serve as a final incentive tool when Texas is competing against another state (TEF, 2015a). Since its inception, the TEF has granted $575 million, with $82.15 million of that in just the last year (TEF, 2015b). Other states—including Florida, North Carolina, New York, and New Jersey—also have such deal-closing funds.

5. Increased transparency and accountability

5.1. Citizens and employees

Stakeholders such as citizen groups, unions, bondholders, credit agencies, and accounting regulators are asking for evidence of tax incentives' efficacy. Tutored by the media, ranging from *The New York Times* to Fox News, the average citizen is becoming educated about how incentives affect his/her wallet. Businesses should anticipate that their incentives packages will eventually be made public, and should be prepared to quantify the return on taxpayers' investment.

Employees of the business receiving incentives see an opportunity to begin asking for job security. Recall the largest incentive deal—$8.2 billion for Boeing in Washington State—which was portrayed as a win-win for all parties. In October 2014, Boeing announced that over 2,000 high-paying jobs supporting the jetliner incentive project were being moved from Washington. In response, unions representing aerospace workers are backing legislation in Washington State that calls for job thresholds and other conditions to be placed on industry tax credits (Wilson, 2014). While Boeing officials maintain they are committed to keeping jobs in Puget Sound, no statutory provisions currently exist to mandate that Boeing meet employment thresholds.

Various other union groups, just like the aforementioned in Washington, have been organizing and fighting for increased transparency regarding incentive packages. Unions also seek assurance that promised jobs will not disappear once all of the awarded incentives have been utilized. Many deals, including parts of the Tesla agreement in Nevada, have already begun to be structured keeping this in mind.

5.2. Policymakers

Tying incentives to actual job creation is one way of ensuring that the tax incentives are working, but many states have found that the *net* jobs created by luring business through incentives are far less than those reported. A few states have implemented evaluation programs into their economic development agencies, and a number of in-house investigations have yielded striking results.

Minnesota, Louisiana, and Massachusetts have fashioned accurate evaluations of their tax incentive programs, providing other states with valuable models—and warnings—of how to evaluate their own programs. Minnesota estimated that 79% of the jobs created at companies receiving incentives were likely to have been generated without the incentives (State of Minnesota, 2008). Louisiana's economic development agency found that 90% of new jobs at companies participating in its Enterprise Zone program were displacing jobs at other employers (Louisiana Economic Development, 2010). Similarly, Massachusetts recognized that providing the film industry tax credits entailed offsetting the cost with cuts elsewhere in the state budget; the film industry created more than 5,900 jobs from 2006 to 2011, many of which were non-resident employment, but the state had to cut more than 3,700 jobs to finance the tax incentives (Pitter, 2014).

Regular evaluations of economic development tax incentives have been few and far between, but state legislators are becoming more supportive of this process. Over the past 4 years, 10 states and the District of Columbia have passed laws requiring periodic evaluations.

In spite of calls for their demise from powerful and influential groups such as the American Legislative Exchange Council (ALEC), it appears that tax incentives for economic development are not going away anytime soon. However, the process of landing incentives and the amount of transparency they require is going to change drastically over the next few years. The highly regarded and aforementioned Texas Enterprise Fund was rocked when, in September 2014, a 107-page audit report raised concerns about nearly every aspect of the program: oversight, selection, reporting, and clawbacks. For example, $222 million—representing nearly 44% of the disbursements—went to entities that did not even submit applications and which were not required to create jobs. The lieutenant governor, who also oversees the TEF, imposed a prohibition on disbursements until the audit recommendations could be implemented.

As states begin to focus in on which deals work and which don't, they will discover much more accurate ways of assigning awards, potentially turning away companies that they would have approached in the past. For example, Kentucky withdrew $18 million in tax incentives from Ark Encounter—a Noah's Ark theme park—because the business had evolved from tourism to ministry, as evidenced by the park's policy to only hire individuals who believed in the biblical flood and who would sign a statement of faith regarding creationism. The developer sued the State of Kentucky in February 2015, claiming violation of free speech.

Research from The Pew Charitable Trusts (2014) has discovered that states interested in measuring incentive effectiveness focus on similar issues:

- Cause and effect: To what extent did tax incentives change businesses' decisions?
- Winners and losers: To what extent did the incentive benefit some businesses or individuals at the expense of others?
- Economics of budget trade-offs: What were the adverse economic impacts of the tax increases or spending cuts made to fund the incentive?

Attempting to answer these questions will not be easy, but under pressure from stakeholders, other states and local governments will begin to develop plans to create an evaluation system of their programs.

5.3. Credit reporting agencies and audited financials

States are not the only parties interested in calculating the effectiveness of billions of dollars of tax incentives; for years, analysts at Moody's and S&P have been hounding states for statistics regarding these breaks. Credit ratings for municipal debt hinge on understanding the claims against future revenue, whether it be pension funding or tax credits and abatements.

To assist in efforts toward transparency and accountability, the Governmental Accounting Standards Board (GASB) proposed tax abatement disclosures that could potentially be required and effective for 2016 reports (GASB, 2014). The current proposal requires aggregate reporting by program and detailed reporting by recipient. The aggregate reporting would be by program for tax abatements that are granted for more than one purpose or by more than one division within the government. The detailed disclosure would, for each reporting year, provide:

- Name of the recipient;
- Amount of taxes abated;
- Duration of tax abatements;
- Other commitments made by the government;
- Commitments made by the tax abatement recipient (i.e., givebacks);
- Recapture provisions, if applicable (i.e., clawbacks); and
- Considerations related to benefits and costs.

Some states are more ready than others to be transparent in tax incentive deals. If this new provision passes, however, every governmental entity must be prepared to comply and businesses should be primed to face a series of articles in local papers about tax subsidies they have received.

5.4. Internal Revenue Service and the European Union

The Internal Revenue Service (IRS) and the European Union (EU) are silent stakeholders in the incentives game. The IRS has had state tax incentives under the microscope as a Tier 1 audit issue. Taxpayers have tried to play the IRS both ways by treating the incentive as a tax-free contribution to capital while claiming a deduction for the full, unabated local tax liability; for example, a taxpayer receiving tax abatement of $200,000 in property taxes would still deduct $200,000. Although the IRS has issued guidance that this tax position is not supported, in some cases tax advisors appear to be giving their clients different advice.

Furthermore, corporations that desire to treat incentives as non-shareholder contributions to capital must satisfy five criteria. While the IRS uses all five as a sword to attack the favorable tax treatment, one criteria—'The contribution must be bargained for'—may increasingly pose a problem. States and local governments are trying to level the playing field and provide a uniform set of incentives in a more transparent manner, but ironically, the backroom side-deals are those that would meet this criteria. The IRS has taken the position that incentives provided by statute would not satisfy the 'bargained for' criteria and thus would not qualify as a tax-free non-shareholder contribution to capital. Businesses that receive state and local tax incentives should take care in reporting for federal income tax purposes.

Finally, partnerships and LLCs—the most common entities for developers and new businesses—cannot treat the incentive as a tax-free non-shareholder contribution to capital contribution because this provision applies only to corporations. Thus, partnerships/LLCs need to consider the federal tax consequences of subsidies, grants, incentives, and reimbursements from the government, the public, and civic groups.

Perhaps more problematic long-term for state tax incentives is the EU's position that these incentives violate World Trade Organization rules about tax jurisdictions providing an unfair advantage (Clark, 2014). For example, the EU claims that the tax incentives provide Boeing with an unfair advantage over Airbus. If the EU's position prevails, Boeing would be required to pay back the taxes to Washington.

6. Recommendations for businesses

Business owners and executives who seek tax incentives should take a lesson from Elon Musk's strategic approach to incentive negotiation. Low taxes do not magically transform a bad location into a good one; cheap and abundant power, geographic desirability, infrastructure, trained workers, and lifestyle amenities such as good schools and quality healthcare are often must-haves to make the short list. Some firms are now considering the implications of investing in a state that is experiencing budget problems; tax incentives from an unstable government should not be regarded as favorably as tax incentives from healthy states.

Encourage jurisdictions to compete against each other. Conduct research to learn about the statutory credits and incentives, and those that have been offered to others in the past; then ask for more. Don't hesitate to lobby and bring media attention to your request, but be sure to have consistent messaging about the main incentives that are desired and the decision factors that will be used. Make it easy for the government to say "yes" by providing economic impact studies of the project based on investment, jobs, and future tax revenues.

Consider whether hiring a consultant is necessary. Business incentive firms can be expensive, charging fees of up to 30% of the incentives received. Most states and local jurisdictions have become very sophisticated in their approach to business incentives. Businesses may find that state government relations or the commerce department is ready to act as an advocate for the business. Therefore, a consultant is often not necessary to achieve a favorable outcome.

Negotiate in good faith. Many firms create different sets of pro forma financials: one favorable to lenders and investors, and another to the jurisdiction offering the incentives which shows a need for assistance to make the project profitable. Expect that governmental agencies may request confirmation the pro forma financials and other supporting documents are identical to those provided investors.

After the incentives are awarded, take care to fulfill all compliance requirements. Implement an accounting system to monitor and report on employment numbers, wages and benefits provided, and investments, in order to avoid triggering clawback provisions. Be proactive in establishing relationships with the community through acts of corporate social responsibility, and track it. In addition, start outreach to incentive review boards, if appropriate. This will increase buy-in from the community and help allay concerns regarding lack of transparency and meaningful oversight of the incentive programs.

Understand the changing regulatory disclosure environment and get ahead of the proposed GASB provisions by creating a tax report for the public. Rio Tinto is a leader in sharing tax information. It annually discloses its economic contribution to public finances.[1] The report demonstrates the economic impact of the company by tallying where it pays taxes and the type of taxes paid by jurisdiction. As with most controversies that will eventually become public information, firms should preempt disclosure to better control the message.

7. Conclusion

These may be the best of times for firms seeking business incentives. State and local governments are aggressively competing for business activity with large amounts on the table, and as of yet there is relatively little disclosure and few givebacks or clawbacks imposed on incentive recipients. The current environment of generous incentive packages, coupled with low interest rates, makes expansion very affordable.

However, executives and business owners should not ignore the changing tax incentive landscape. If statistics similar to those found in Minnesota, Louisiana, and Massachusetts are exposed through other state evaluations, businesses could see smaller incentive packages and fewer states fighting each other to win their new manufacturing facilities or company headquarters. As states increase transparency of incentive packages and hone evaluation techniques, businesses should only make promises about jobs and investments that they can keep.

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[1] Rio Tinto's 2013 tax report can be found at http://www.riotinto.com/documents/RT_taxes_paid_in_2013.pdf