The Future of Incentives Agreements: What is the Impending Impact of COVID-19 Economics?

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How prepared we are to adapt to our new economic circumstances will make a difference in the outcomes achieved. Some clients have asked whether business incentives will disappear as the federal government wrestles with new demands and lower revenues. State and local governments, especially those with balanced budget requirements, will be even more constrained.

> *We cannot direct the wind, but we can adjust the sails.* – **Thomas S. Monson**

Interestingly, history indicates this may not be the case. Federal agencies and many state and local governments have already responded to the COVID-19 crisis with programs designed to ensure that businesses survive. With the heightened need to increase employment opportunities, this support is likely to continue. Companies that have made investments and created jobs may have business and economic incentives agreements in place whose requirements are now impossible to meet according to the timelines anticipated when agreements were signed. The important response is to understand the exposures and develop a strategy to approach each commitment. At the same time, a great many companies have been designated as "essential services" and are hiring and investing to keep up with unexpected increases in demand.

While there are more questions than answers at this juncture, this paper will highlight important topics and outline some preliminary considerations for business decision makers regarding incentive programs, whether their businesses are facing cutbacks or growth in the current environment.

Are Incentives Over?

Are you wondering if incentives will dry up now that federal, state and local government resources are stretched to the maximum limits? While possible, this is unlikely. States consider incentive programs as an important tool to bring jobs and capital investment to their local economies, by helping businesses offset both up-front capital and expenses and ongoing operating expenses. States have a long history of competing for new job creation and capital investment. Competition between states will intensify as state and local governments promote the business advantages and better returns that they offer compared to other location options.

All levels of government are now starting to envision how to safely balance public health with the imperative to restore economic activity. Any expansion or new investment is risky from a company's liquidity, cash flow and P&L performance perspective, even in a normal economic cycle. At exactly the moment when a company has the greatest risks (and impeded revenue), development costs impact their financials at the highest levels. These financial impacts include higher depreciation expenses for building and equipment, property taxes and finding and training new employees while betting on supporting increased sales.

State and local governments have always played an active role in incenting businesses to relocate or remain in their jurisdictions by helping mitigate the risk for these new investments. Numerous scholars have questioned the relevance or necessity of these subsidies; however, seasoned site selectors understand that without these benefits, which often solve development problems or logistics and labor differences, there would not be a transaction. Often, businesses cannot afford to fix site-specific shortcomings, such as a wastewater treatment plant that has not had maintenance for 15 years and needs $5 million in rehabilitation or extending a water main line to a greenfield site two miles away.

Some state and local programs, while important, may be at risk because they are not self-funding. For example, a program that requires an allocation by a state's legislative budget funding process without a specific funding source, such as governors' quick action closing funds, could be at risk, particularly in states with balanced budget requirements.

Safer are self-funding programs, which tie benefits to incremental revenues generated from the project itself. The saying, "You cannot tax what you do not have" explains this concept. The state and local governments will not gain project-specific revenues unless the project locates in their respective jurisdictions. To illustrate, some governments are willing to abate/rebate property taxes generated from a new project because these revenues are incremental to the existing tax base.

One state that has an interesting funding program is Ohio. Its major program, Jobs Ohio, is funded by liquor business sales. This program is in good shape as, according to an article published in the *Daily Beast* by Emma Tucker, "Liquor sales have soared nationally by 55%, reported Nielsen at the end of March 2020, as the country shelters in place."

Are Clawbacks Enforceable with Mandated Shutdowns?

Incentives are awarded on a contingent basis on investment and/or job creation. Our current response to the COVID-19 crisis makes it impossible, at least in the short run, for some companies to meet the agreed-upon criteria. Reporting periods are quarterly or annually, depending on the program.

For example, many agreements require job creation at certain locations and specifically exclude or limit the number of employees allowed to work at home to qualify for benefits. Our new normal turns this notion upside down, as many states have mandated working from home and specific closures of facility types like all non-essential call centers, factories and offices.

These new federal and state edicts are in direct conflict with many of the rules and regulations that guide the statutory compliance for business and incentive programs. It is a difficult argument for federal, state and local governments to assert, however, that a given company is noncompliant if the government's own decrees are preventing performance.

If the past is any indicator, there will be leniency, as most state and local governments have agreed that events like 9/11 and the Global Financial Crisis of 2008 were extraordinary. Legally, the courts have not supported the concept of *force majeure.* In Ken Adams' blog, "On Contract Drafting," he noted the analysis of Baker Botts corporate counsel Kevin Jacobs and Benjamin Sweet:

> "Thus far, courts continue to resist applying this contractual provision to even the most severe economic events. Nevertheless, courts have indicated a willingness to consider recessions as force majeure events, if the parties intended such events to be covered by their contracts." This means if the contract specifically mentions the relevant situation as qualifying as force majeure. "Even if a party can show COVID-19 (a pandemic) or its effects are covered by the clause at issue, it still has the task of demonstrating…that performance is truly impossible rather than merely financially difficult."

Our COVID-19 journey is unprecedented, as governments have never mandated such widespread shutdowns of businesses. Will state and local governments grant leniency with respect to incentive contract performance and how long will it last are unknowns. Another question is the viability of enforcing clawback provisions, considering that these mandated closures are new territory, especially if they lead to foreclosures. Furthermore, in almost all incentive contracts, a business foreclosure creates a noncompliance issue, and thus technically could trigger clawbacks.

Repercussions from the above circumstances are not yet determined, but they deserve consideration as performance is evaluated and clawbacks are negotiated.

Net Operating Loss Positions May Risk Income Tax Credits

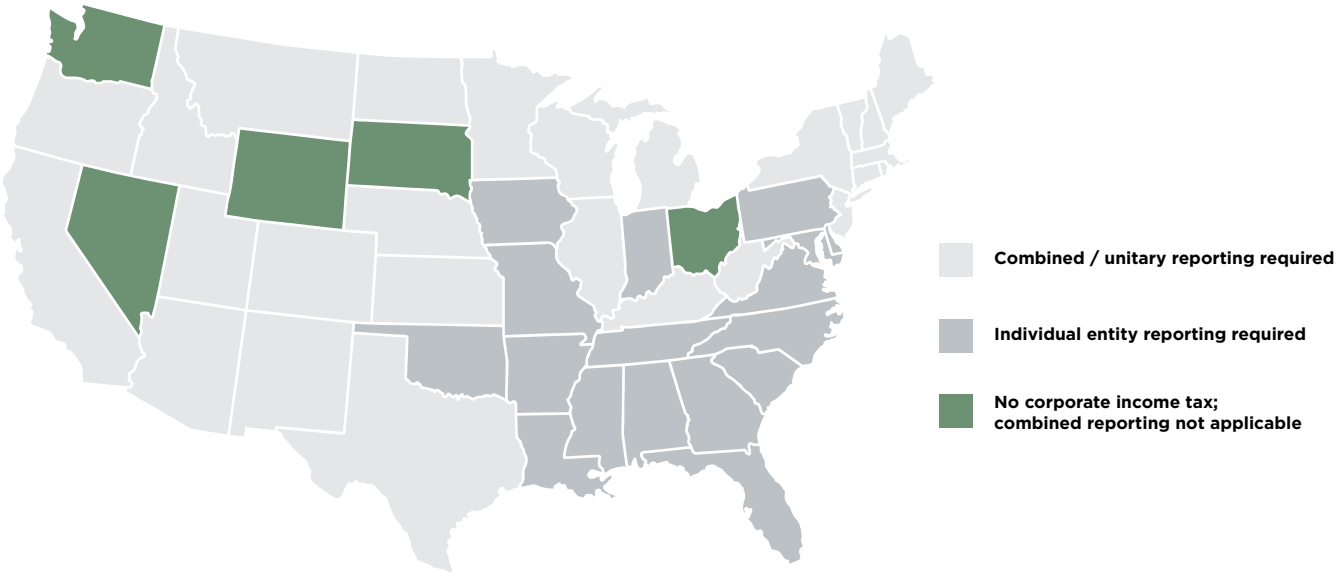
Some incentives are structured as income tax credits. In a sea change of events with COVID-19, many companies may find their fortunes impacted by circumstances completely out of their control. Credits are utilized only when there are income tax liabilities to offset, and now for some companies, this is problematic.

If a business is in a net loss position or generates net operating losses (NOLs), they often cannot utilize these important earned tax credits. A state's tax requirement status as unitary or single filing, and the company's legal structure, will determine the company's ability to leverage credits.

In a unitary filing state, for income tax filing purposes, all legal entities roll up to the parent company. If one legal entity has a net operating loss, but the parent overall still generates income with its other combined entities, these incentive income tax credits are usable.

Alternatively, in a single entity filing state, net operating losses are not offset by other corporate affiliates as each entity must file separate income tax returns, and therefore is unable to utilize income tax credits. Figure 1 shows which states have unitary or single filing requirements. Most credit programs have carry-forward periods of five to 10 years for unused credits; however, credits you may have thought you qualified for this year could have evaporated with unexpected losses.

FIGURE 1:
Required Combined Reporting for the State Corporate Income Tax



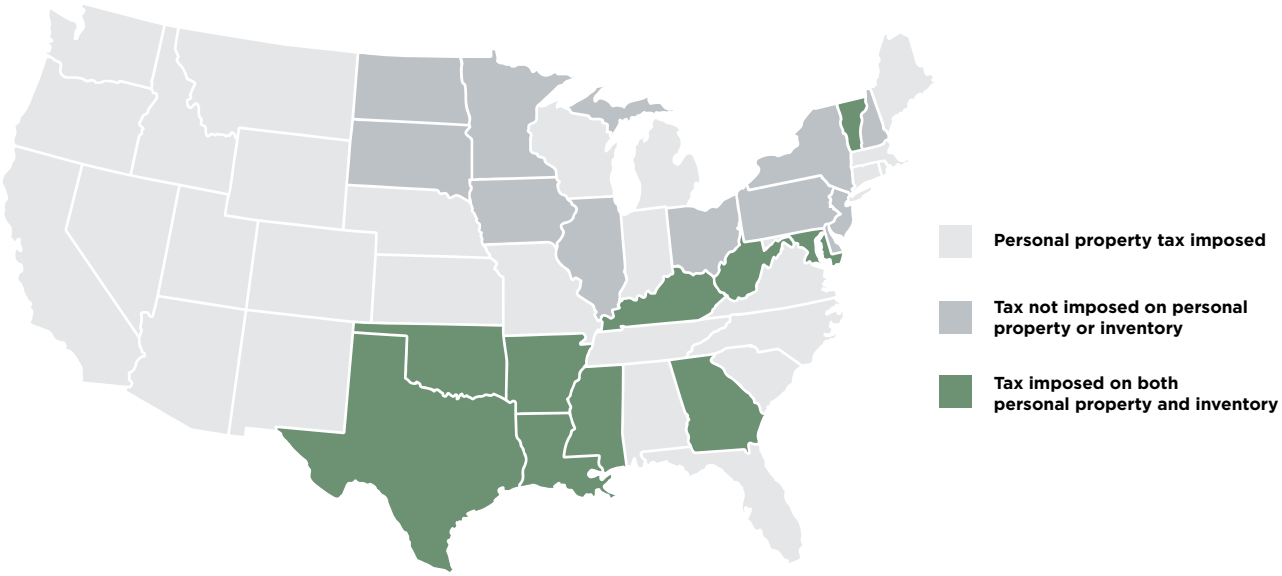
NOTE: Unitary reporting treats a parent company and its subsidiaries as one entity for state income tax purposes, thereby helping prevent income shifting

Freeport Exemptions: Slower Sales May Affect Eligibility

A chain reaction of slower sales may mean your inventories are not moving out of the respective inventory tax state in order to qualify for freeport exemptions. Most inventory taxed states (see Figure 2) require that goods sold outside of a given state must leave within 175 days. Consequently, if goods remain longer than 175 days, an additional property tax liability could be an unintended consequence.

Short-term demand or lack of demand must be evaluated and adjusted with logistics professionals to ensure these additional cost events do not ensue.

FIGURE 2:
Tax on Personal Property & Inventory by State



NOTE: 1) Georgia does not impose a tax on inventory at the state level
2) Michigan has passed legislation which phases out the personal property tax for commercial / manufacturing property beginning in 2016

Companies in Certain Industries Thrive

Rapidly changing consumer behaviors are already impacting the real estate landscape in retail operations, transportation, manufacturing (due to shortages of parts produced in other countries) and essential services companies such as pharma, healthcare and food. These businesses will likely make investments in both distribution and manufacturing facilities, creating more jobs, and thus becoming eligible for federal and state incentives.

Businesses that have flourished thus far during COVID-19 are trying to determine if their increased success is sustainable or if it will level off at some incremental increase. If increases in demand require investment and permanent job creation, then incentives are likely available to them to offset the costs of expanding.

Supporting the notion that the economy is already responding to the change in needs, labor market data experts at economic modeling firm Emsi indicate that job postings have increased over the last 30 days in certain sectors, including distribution, cloud creating capacity, software development, food, medical and accounting.

According to Randyl Drummer, writing in CoStar News on April 3, "Over 800 industrial leases have been signed since mid-March…Online retailer Amazon, shipping company FedEx and other businesses signed hundreds of leases for warehouse and logistics space in the first weeks of the pandemic's spread across the U.S."

Further, the travel restrictions imposed by many countries to limit the spread of COVID-19 may increase the likelihood of reshoring, as companies seek to repair broken supply chains by bringing back to the U.S. some or all of a company's off-shore operations and distribution networks.

Review Your Incentives in a New Light

In summary, these are unprecedented and difficult times, with no map to navigate the uncharted waters. The federal government has already reacted by implementing important incentive changes, and state and local governments are likely to continue to support companies in their efforts to invest and grow. It is crucial that companies review their incentive commitments for the projects they have, in light of capital and headcount pledges, to determine both incentives at risk and to strategize ways to combat clawback exposures. At the other end of the economic spectrum, for those companies that are thriving despite the extraordinary environment, there are incentives that will help offset costs associated with business expansion and ensure their continued survival.

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