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Memorandum

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from: Curt Wilson
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subject: Generic Legal Advice - Excessive payments received under ARRA section 1603

This Chief Counsel Advice responds to your request for advice on the federal income tax treatment of the receipt of excessive payments under section 1603 of American Recovery and Reinvestment Tax Act of 2009 (ARRA). This advice may not be used or cited as precedent.

Issues

1. In the event the Service determines that a taxpayer's project did not qualify for all or part of a section 1603 payment, is the excessive amount of the payment includible in the taxpayer's gross income under § 61, notwithstanding § 48(d)(3)(A), which states that section 1603 payments shall not be includible in the taxpayer's gross income?

2. If the excessive amount of a section 1603 payment is not excluded from income under § 48(d)(3)(A), are any other exclusions applicable to the section 1603 payment?

3. If the excessive amount of a section 1603 payment is not excludible from income, what are the accounting effects? For example, if a taxpayer receives a payment in year one and repays it to Treasury in year one, is there income and a deduction in year one? If a taxpayer receives a payment in year one and repays it to Treasury in a subsequent year, is there income in year one and a deduction in the subsequent year?

4. If the Service determines that a taxpayer's project did not qualify for all or part of a section 1603 payment, how is the taxpayer's basis in the project calculated? Does the taxpayer, under § 48(d)(3)(B), still reduce its basis by one-half of the entire amount of the payment including the excessive amount?

Conclusions

1. In the event the Service determines that a taxpayer's project did not qualify for all or part of a section 1603 payment, the excessive amount of the payment is includible in the taxpayer's gross income under § 61, notwithstanding § 48(d)(3)(A).

2. We have found no other provisions that apply to exclude from gross income the excessive amount of a section 1603 payment.

3. A taxpayer that receives a section 1603 payment must include any excessive amount of the payment in gross income in the taxable year that the taxpayer receives the payment. The taxpayer may deduct repayment of the excessive amount in the taxable year of the repayment. However, if a taxpayer receives an excessive amount in the same taxable year that the taxpayer repays the excessive amount, the taxpayer does not include the excessive amount in gross income and does not deduct the repayment.

4. A taxpayer's basis in a project for which the taxpayer receives an excessive amount is not reduced by the excessive amount in either the taxable year of receipt or the taxable year of the repayment.

Background

President Obama signed the ARRA into law on February 17, 2009. ARRA section 1603, as amended by section 707 of the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (TRUIRJCA), appropriated funds for payments to applicants who place specified energy property in service during 2009, 2010, or 2011 (section 1603 payments). Section 1603 payments can be made for specified energy property placed in service after 2011 if construction began on the property during 2009, 2010, or 2011 and the property is placed in service by the specified credit termination date. The amount of a section 1603 payment is either 30 percent or 10 percent of the project's basis depending on the type of property placed in service. The Department of the Treasury's Office of the Fiscal Assistant Secretary administers ARRA section 1603.

ARRA section 1104 added § 48(d) to the Internal Revenue Code (Code). Section 48(d) provides that (1) a taxpayer may not take a § 45 or § 48 credit for the property for which Treasury makes a section 1603 payment and (2) a taxpayer must recapture any § 48 credit allowed in prior years for the property in the year the taxpayer receives a section 1603 payment for the property. In addition, § 48(d)(3) provides that a

section 1603 grant is not included in income and the basis of the specified energy property is reduced by one-half of the section 1603 payment.

You have requested assistance about the tax treatment of a section 1603 payment if the Service, on examination, determines that a project for which a section 1603 payment was made did not qualify for all or a portion of the payment.

Law and Analysis

ARRA section 1603 (as amended by TRUIRJCA section 707) directs Treasury to make cash payments to persons who place in service specified energy property to reimburse such persons for a portion of the expense of such property. The specified energy property can be placed in service in 2009, 2010 or 2011, or the specified energy property can be placed in service after 2011 if construction began on the property during 2009, 2010, or 2011 and the property is placed in service by a specified credit termination date.

Section 1603(d) of ARRA provides that the term specified energy property includes only property for which depreciation (or amortization in lieu of depreciation) is allowable. Depreciation or amortization in lieu of depreciation is only allowable for property used in a trade or business or for the production of income. Section 167 of the Code.

Exclusion under Section 48(d)(3)

ARRA section 1104 added § 48(d) to the Code. Section 48(d)(1) denies otherwise allowable tax credits under §§ 45 and 48 to section 1603 payment recipients. Section 48(d)(2) requires the recapture of credits for progress expenditures for the taxable year in which a section 1603 payment is made for qualifying property. Section 48(d)(3)(A) excludes section 1603 grants from gross income. Section 48(d)(3)(B) provides that basis in the property is reduced by one-half of the amount of the section 1603 payment.

Section 48(d)(3)(A) provides that any grant under the section 1603 program “shall not be includible in the gross income of the taxpayer.” This provision is strictly construed. For purposes of § 48(d)(3)(A), the term “grant under the section 1603 program” does not include the portion of any payment that a taxpayer receives under the section 1603 program that exceeds the amount of the section 1603 payment that applies to the cost of property that qualifies for the payment under section 1603 of ARRA. Thus, if the Service determines, on examination, that a taxpayer’s property did not qualify for all or part of the payment that the taxpayer received for the property under the section 1603 program, the excess over the amount of the correctly determined section 1603 payment for that property is not excludible from the taxpayer’s gross income under § 48(d)(3)(A). Since this excess portion of a payment made under

the section 1603 program is not excludible under § 48(d)(3)(A), we look to see if these excessive payments are excludible under any other Code provision.

Excessive payments

If a payment is made under the section 1603 program for a project that was placed in service before 2009, the entire section 1603 payment is excessive because the project does not meet the placed in service requirements of ARRA section 1603(a). In the case of a lessor passing through a section 1603 payment to a lessee of specified energy property, a partially excessive section 1603 payment results from use of an amount in excess of the fair market value of the property to determine the amount of the section 1603 payment. Section 1603 provides that in making grants under this section, the Secretary of the Treasury shall apply rules similar to the rules of section 50 of the Internal Revenue Code of 1986. Section 50(d)(5) provides that rules similar to the rules of § 48(d) (as in effect on the day before the date of the enactment of the Revenue Reconciliation Act of 1990) apply for certain leased property. Under this former § 48(d), for certain property, a lessor could elect to treat the lessee as having acquired such property for an amount equal to the fair market value of the property. Treasury's program guidance for making payments under section 1603 provides:

A lessor who is eligible to receive a Section 1603 payment with respect to a property may elect to pass-through the Section 1603 payment to a lessee. The election may only be made with respect to property that would be eligible for the Section 1603 payment if owned by the lessee. Such an election will treat the lessee as having acquired the property for an amount equal to the independently assessed fair market value of the property on the date the property is transferred to the lessee and will generally follow the rules in the IRC and Treasury regulations governing elections to allow lessees to receive energy tax credits.

Thus, if a lessor passes the section 1603 payment through to a lessee and that payment to the lessee is based on an amount in excess of the fair market value of the property, the lessee has received a partially excessive section 1603 payment. The amount of the excess is the product of the credit rate that applies for the property and the excess of the amount on which the credit was paid over the fair market value of the property.

Section 61

Section 61(a) provides that, except as otherwise provided by law, gross income means all income from whatever source derived. The Supreme Court has repeatedly emphasized the "sweeping scope" of § 61 and has recognized that Congress intended through § 61 to exert the "full measure of its taxing power." *Commissioner v. Schleier*, 515 U.S. 323 (1995), 115 S. Ct. 2159, 132 L. Ed. 2d. 294; *United States v. Burke*, 504 U.S. 229 (1992), 112 S. Ct. 1867, 119 L. Ed. 2d 34. See also *Sprint Nextel Corp. and Subsidiaries v. U.S.*, --- F.Supp.2d ---, 2011 WL 836738, at *1 (D. Kan. 2011). Under

§ 61, Congress intends to tax all gains and undeniable accessions to wealth, clearly realized, over which taxpayers have complete dominion. *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955), 75 S. Ct. 473, 99 L. Ed. 483, 1955-1 C.B. 207.

The Supreme Court has also emphasized that the corollary to § 61's broad construction is the "default rule of statutory construction that exclusions from income must be narrowly construed." *Burke* at 328. "Exemptions, exclusions, and other provisions treating income as nontaxable occur as a matter of legislative grace and should remain strictly construed." *De Aycardi v. Commissioner*, T.C. Memo. 1997-308 (citations omitted). "A taxpayer is entitled to an exclusion only if there is clear provision for the favorable tax treatment." *Id.* (citation omitted).

In *De Aycardi*, the taxpayer claimed that dividend and interest income from her mutual fund investment qualified as nontaxable under § 871(h). Under § 871(h), portfolio debt interest paid to nonresident aliens is nontaxable. *Id.* The taxpayer argued "that the mutual fund misclassified her status as a U.S. resident for Federal income tax purposes and incorrectly invested ... in a mutual fund on which both interest and dividends were earned" and that "had the dividends been received as interest, the interest would have been treated as nontaxable under section 871(h)." *Id.* Although the interest income was nontaxable and the dividend income would have been paid as interest income had the mutual fund investment been structured to pay only portfolio debt interest income, the court stated that it "treat[s] facts as they happened, not how they could or might have happened in the ideal situation for a taxpayer." *Id.* The court then held that the dividend income from the mutual fund investment "does not qualify as nontaxable interest income under section 871(h)." *Id.*

Gross income includes payments under governmental programs, unless a specific statutory exception applies. For example, grant payments made by the Empire State Development Corporation to businesses to aid recovery from the attack of September 11, 2001, on the World Trade Center are included within the broad definition of gross income under § 61 and, generally, do not qualify for any exclusion under the law. Notice 2003-18, 2003-1 C.B. 699. See also Rev. Rul. 79-356, 1979-2 C.B. 28 (grants paid by a state to homeowners and builder/developers under the Department of Housing and Urban Development's residential Solar Hot Water Initiative Program are includible in the recipients' gross income under § 61).

The Service, however, 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"). See, e.g., Rev. Rul. 74-205, 1974-1 C.B. 20; Rev. Rul. 98-19, 1998-1 C.B. 840. 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. Rev. Rul. 75-246, 1975-1 C.B. 24; Rev. Rul. 82-106, 1982-1 C.B. 16. Payments to businesses generally do not qualify under the general welfare exclusion

because the payments are not based on individual or family needs. See *Bailey v. Commissioner*, 88 T.C. 1293, 1300-1301 (1987), *acq.*, 1989-2 C.B. 1; Rev. Rul. 76-131, 1976-1 C.B. 16; Notice 2003-18.

Property qualifies for a section 1603 payment only if the property is used in a trade or business or for the production of income. Thus, a section 1603 payment is not intended to help individuals cope with their individual or family needs (e.g., housing, education, and basic sustenance expenses). Therefore, section 1603 payments do not qualify for exclusion from gross income under the general welfare exclusion.

Gift

Section 102(a) provides that the value of property acquired by gift is excluded from gross income. Under § 102(a), a gift must proceed from a “detached and disinterested generosity,” . . . ‘out of affection, respect, admiration, charity or like impulses.’” *Commissioner v. Duberstein*, 363 U.S. 278, 285, 80 S. Ct. 1190, 4 L. Ed. 2d 1218 (1960), 1960-2 C.B. 428. On the other hand, payments that proceed “primarily from the ‘constraining force of any moral or legal duty’ or from ‘the incentive of anticipated benefit’ of an economic nature” are not gifts. *Duberstein* at 285. In Notice 2003-18, the Service concluded that grant payments made under the World Trade Center grant programs are not excluded from a grant recipient’s gross income as gifts under § 102 because the intent of the federal, state, and local governments in making the grant payments proceeds, not from charity or detached and disinterested generosity, but from the government’s duty to relieve the hardship resulting from the disaster and the economic benefits it anticipates from a revitalized New York City economy. Neither the acts that appropriated the funds nor the legislative history of those acts indicates a donative intent. Instead, Congress indicated that the grant funds were for “economic revitalization,” to help New York City in its “overall economic recovery”, and to assist the “economic recovery” of areas affected by the terrorist attack.

ARRA section 3(a) provides that the purposes of that Act include the following: (1) preserving and creating jobs and promoting economic recovery, (2) assisting those most impacted by the recession, (3) providing investments needed to increase economic efficiency by spurring technological advances in science and health, (4) investing in transportation, environmental protection, and other infrastructure that will provide long-term economic benefits, and (5) stabilizing state and local government budgets, in order to minimize and avoid reductions in essential services and counterproductive state and local tax increases.

Neither ARRA nor its legislative history indicates that the government’s intent in making section 1603 payments proceeds from charity or detached and disinterested generosity. Instead, the purposes of a section 1603 payment are most consistent with the purposes set forth in ARRA section 3(a)(1), (3) and (4) of promoting economic recovery and long-term economic benefits and spurring economic efficiency. Even if the purposes of a section 1603 payment were to assist those most impacted by the

recession and to minimize and avoid reduction in essential services, as set forth in ARRA section 3(a)(2) and (5), the payment would not qualify as a gift under § 102 because a government can expect an economic benefit from programs that relieve business or individual hardships. Notice 2003-18. *See also Kroon v. United States*, Civil No. A-90-71 (D. Alaska 1974), 1974 WL 629. Thus, a section 1603 payment does not qualify for exclusion from gross income as a gift under § 102(a).

Contribution to capital of a corporation

Section 118(a) provides an exclusion from gross income for, in the case of a corporation, any contribution to the capital of the taxpayer. This section applies to capital contributions made by shareholders as well as to capital contributions made by persons other than shareholders. Treas. Reg. § 1.118-1. 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.

In *United States v. Chicago, Burlington & Quincy_R.R.*, 412 U.S. 401(1973), the Court considered whether a taxpayer was entitled to depreciate the cost of certain improvements that had been funded by the federal government. The Court held that the government subsidies were not contributions to the taxpayer's capital. The Court identified the salient characteristics of a nonshareholder contribution to capital: (1) it must become a permanent part of the transferee's working capital structure; (2) it may not be compensation, such as a direct payment for a specific, quantifiable service provided for the transferor by the transferee; (3) it must be bargained for; (4) the asset transferred must foreseeably result in benefit to the transferee in an amount commensurate with its value; and (5) the asset ordinarily, if not always, will be employed in or contribute to the production of additional income and its value assured in that respect.

The excessive payments that taxpayers receive under section 1603 of ARRA are not nonshareholder contributions to capital within the meaning of § 118(a).¹ The failure to strictly meet the statutory requirements for exclusion from income results in inclusion in income. Section 118 does not provide an exclusion where the government has no

¹ We note that § 118 applies only to corporations, including LLCs treated as a corporation for federal income tax purposes. Section 118 does not apply to an LLC treated as a partnership for federal income tax purposes. Therefore, if a taxpayer is not a corporation or an LLC treated as a corporation the payment is not eligible for exclusion under § 118(a).

intent to make a contribution to capital. The “expectation of the contributors” of section 1603 payments was not to make a capital contribution. See, e.g., *Chicago, B & Q. R. Co.*

No basis for exclusion

We have found no provision of the Internal Revenue Code that excludes from income the excessive amount of a section 1603 payment.

Accounting treatment

Section 162(a) allows a taxpayer to deduct all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

Section 165 allows a taxpayer to deduct an uncompensated loss in the year sustained.

Section 451(a) provides that the amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

For a taxpayer on the cash method of accounting, income is includible in the tax year in which the income is actually or constructively received by the taxpayer. Under an accrual method of accounting, income is includible in gross income when all events have occurred that fix the right to the income and the amount of the income is reasonably determinable. All events that fix the right to receive income occur when: (1) the required performance takes place, (2) payment is due, or (3) payment is made, whichever happens earliest. See *Schlude v. Commissioner*, 372 U.S. 128 (1963), 83 S. Ct. 601, 9 L. Ed. 2d 633, 1963-1 C.B. 99; Rev. Rul. 80-308, 1980-2 C.B. 162.

Section 461(a) provides that the amount of any deduction or credit allowed by Subtitle A of the Internal Revenue Code shall be taken for the taxable year that is the proper taxable year under the method of accounting used in computing taxable income.

For a taxpayer on the cash method of accounting, liabilities are generally deductible in the year in which they are paid. Under an accrual method of accounting, a liability is generally deductible in the taxable year in which all events have occurred that establish the fact of the liability, the amount of the liability is reasonably determinable and economic performance has occurred with respect to the liability. Economic performance for rebates, refunds, similar liabilities and liabilities not specified elsewhere in § 1.461-4 occurs upon payment.

A taxpayer that receives a section 1603 payment must include any excessive amount of the payment in gross income in the taxable year that the taxpayer receives

the payment. The taxpayer may deduct repayment of the excessive amount in the taxable year of the repayment. However, if a taxpayer receives an excessive amount in the same taxable year that the taxpayer repays the excessive amount, the taxpayer does not include the excessive amount in gross income and does not deduct the repayment.

Basis reduction

Section 48(d)(3)(B) generally provides that basis in the property is reduced by one-half of the amount of the section 1603 payment. If the taxpayer was not entitled to all or a portion of a section 1603 payment, the excessive amount of the payment does not constitute a section 1603 payment. If the excessive payment does not constitute a section 1603 payment, then the excessive payment does not meet the statutory requirements for a one-half reduction in basis under § 48(d)(3)(B). A taxpayer that receives an excessive payment should not reduce the basis of the qualified energy property by one-half of the amount of the excessive payment either in the year of receipt or in the year of repayment.

I hope this is helpful to you. If you have any further questions, please call Brian J. Americus at (202) 622-3110.