

**Office of Chief Counsel
Internal Revenue Service
Memorandum**

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to: Associate Area Counsel
(Small Business/Self-Employed)
CC:SBSE:DEN:LV

from: Acting Chief, Branch 3
Associate Chief Counsel
(Income Tax and Accounting)
CC:ITA:3

subject: Nevada State Payments

This Chief Counsel Advice responds to your request for expedited assistance. This advice may not be used or cited as precedent.

You have requested Chief Counsel Advice from us in order to assist you in responding to inquiries concerning the federal tax treatment of two legislative proposals in the State of Nevada. You have described the facts as follows.

FACTS

The state has collected an excess of approximately \$600 million in general fund revenue during the fiscal years 2003-04 and 2004-05, and the state is considering returning approximately \$300 million to its citizens during calendar year 2005. The state general fund is comprised of a variety of revenue streams. The primary sources are gaming taxes; sales and use taxes; the insurance premium tax; and the modified business tax. The state does not have a personal income tax.

The state has identified two potential methods of returning the \$300 million to its citizens. Each method would use a database of the Department of Motor Vehicles (DMV) because the state has no other database from which to identify its citizens.

The first method would be to pay an equal amount to each resident who held a state driver's license or DMV-issued state identification card on July 1, 2004, and was at least 18 years of age by a specified date in 2005. A check of approximately between \$150 to \$190 would be sent to each such individual.

The second method would be to make a payment based on the vehicle registration fee and governmental services tax paid when registering a vehicle during 2004. The registration fee was \$33 during calendar year 2004, and it may be deductible under § 162(a) of the Code for a taxpayer engaged in a trade or business. The governmental services tax is an annual ad valorem tax in respect of personal property, and it is deductible under § 164(a)(2) of the Code. A check would be mailed to each person who had a vehicle registered in the state during 2004. A person who had multiple vehicles registered would receive a payment with respect to each vehicle. The payments would not exceed \$300 per vehicle.

Both methods could be viewed as either a means of identifying (1) a class of recipients (number of persons) entitled to "payments" without regard to prior payments to the state or (2) the persons entitled to "refunds" as a result of having made prior payments to the state. Our discussion will describe the effect of both approaches without deciding the proper characterization for each method.

DISCUSSION

1. Taxability of Payments

Section 61(a) of the Internal Revenue Code provides that, except as otherwise provided, gross income means all income from whatever source derived. Payments received from a state government are includible in gross income under § 61 unless excluded from gross income by law. See Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 431, reh'g denied, 349 U.S. 925 (1955) (holding gross income encompasses any item representing "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion"). Consequently, the proposed state payments would be taxable to recipients, unless the payments were either gifts or tax refunds.

A. Gift Characterization

Section 102(a) of the Code provides that gross income does not include the value of property acquired by gift. Neither the Code nor legislative history accompanying § 102 defines the term gift.

A leading authority on the meaning of the term gift for § 102 purposes is Duberstein v. Commissioner, 363 U.S. 278 (1960). In Duberstein, the Supreme Court explained that a gift proceeds from a "detached and disinterested generosity," and is made "out of affection, respect, admiration, charity or like impulses." If a payment proceeds primarily from "any moral or legal duty" or from "the incentive of anticipated benefit" of an economic nature, it is not a gift.

Kroon v. United States, 74-2 U.S.T.C. 9641 (D. Alaska 1974), involved homeowners who received payments by the State of Alaska pursuant to the Alaska Mortgage Adjustment Program to retire the mortgages on residences destroyed by an earthquake. The court held that the payments were not gifts under § 102 and were includible in the homeowner's gross income because the payments were prompted out of the state's moral obligation to its citizens rather than out of charity and disinterested generosity. The court stated:

The government and a private donor differ in nature. Whereas in some instances a payment from the government and a private donor could both be classed as gifts, in this instance the government owes a type of duty not incumbent upon a private donor to relieve hardship caused by a natural disaster. Alternatively, it may be contented that the government benefits more than a private donor in these situations in that a stronger economy increases the tax base.

Id. See also Foley v. Commissioner, 87 T.C. 605 (1986) (holding that payments from the West Berlin government to its residents and workers designed to encourage consumption and spending to improve West Berlin's economic vitality were not gifts under § 102); Beattie v. United States, 635 F. Supp. 481 (D. Alaska 1986), aff'd, 831 F.2d 916 (9th Cir. 1987), cert. denied, 485 U.S. 1006 (1988).

In certain situations, a payment by a government has been treated as a nontaxable gift under § 102. See Rev. Rul. 55-609 (death gratuity payments specifically designated by Congress as gifts); Rev. Rul. 68-158, 1968-1 C.B. 47 (holding state payments to or on behalf of veterans who served in the Armed Forces during war time were not includible in gross income); and Dewling v. United States, 101 F. Supp. 892 (Ct. Cl. 1952) (holding payments from the federal government were gifts in recognition of the services rendered for construction of the Panama Canal built thirty years prior to payment). However, in many cases the government payments fail to be gifts under § 102 because the payments are made in anticipation of future benefits. See Rev. Rul. 2003-12, 2003-3 I.R.B. 283; Notice 2003-18, 2003-1 C.B. 699 (grants of September 11, 2001, aid were not gifts because legislative intent 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); Rev. Rul. 85-39, 1985-1 C.B. 21 (Alaska dividend payments were not gifts because legislative intent indicated one of the purposes behind the payments was "reducing population turnover resulting in a more stable political, economic, and social environment"); and Rev. Rul. 76-131, 1976-1 C.B. 16.

Whether the payments made by the State of Nevada to its citizens are gifts under § 102 depends on all the facts and circumstances. We cannot definitively determine at this time whether the payments contemplated by the State of Nevada would qualify as nontaxable gifts. In general such payments would not qualify as nontaxable gifts. It generally is not the purpose of governments to make gifts to its citizens. When payments by governments have been treated as nontaxable gifts the payments generally have been made to a class of individuals and the payments based on the activities of that class, such as veterans who served in the armed forces during a certain war, or individuals who worked on the construction of the Panama Canal. As proposed, the payments are not limited to a class of recipients based on merit or service. See Rev. Rul. 76-131 and Rev. Rul. 85-39.

Unless the proposed payments were classified as a gift to a class, the payments would be taxable to the recipients under § 61.

B. Refund Characterization

A payment from the state under either method could be viewed as a refund of a prior payment made to the state. The tax treatment of such refund depends on whether or not the initial payment to the state was deductible for federal income tax purposes. Under § 61 of the Code, a refund of a payment is includible in income when the underlying payment was deducted and generated a tax benefit.

Generally, the tax benefit rule requires a taxpayer who received a tax benefit from a deduction in an earlier year to recognize income in a later year if there occurs an event that is fundamentally inconsistent with the premise on which the deduction was initially based. Hillsboro National Bank v. Commissioner and United States v. Bliss Dairy, Inc., 460 U.S. 370 (1983); see also § 111. If a taxpayer receives Nevada state payments as a recovery of the payments which the taxpayer deducted in a prior year, then the taxpayer has income to the extent that the prior deduction resulted in a tax benefit.

Refunds made under either method are subject to the tax benefit rule only to the extent that the taxpayer took a deduction in a prior year for that payment. For example, a taxpayer who took a federal income tax deduction (e.g., Schedule A or Schedule C) for personal property taxes would be taxable on the recovery of those taxes to the extent the taxpayer benefited from the deduction. Likewise, a taxpayer who did not take a federal income tax deduction for personal property taxes would not be taxable on the recovery.

In sum, if payments received from the state represent refunds of previously deducted amounts, then the taxpayer must include in income such amounts to the extent that the prior deduction resulted in a tax benefit.

C. Conclusion

If the payments from the state constitute a gift to a class of recipients based on merit or service (rather than a refund), such amounts are not included in gross income under § 61. However, from the information available, it does not appear that the proposed payments qualify as excludible gifts. If the payments represent a refund of previously paid amounts, then such refunds are included in the recipient's gross income to the extent that the tax benefit rule applies.

2. Information Reporting Requirements

Section 6041(a) of the Code provides, in part, that all persons engaged in a trade or business and making payment in the course of such trade or business to another person of rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable gains, profits, and income of \$ 600 or more in any taxable year shall render a true and accurate return to the Secretary, under such regulations and in such form and manner and to such extent as may be prescribed by the Secretary, setting forth the amount of such gains, profits, and income, and the name and address of the recipient of such payment. Section 6041(d) provides that every person required to make a return under section 6041(a) shall furnish certain information to each person with respect to whom such a return is required.

Sections 1.6041-1(b)(1) and (g) of the Income Tax Regulations provide that payments made by a state or a political subdivision are subject to this reporting requirement.

Under the first method for returning the \$300 million to Nevada citizens, the state will be issuing payments of less than \$600 to each individual. Accordingly, there is no reporting requirement under § 6041 for the payments under the first method.

Under the second method, payments constituting a refund of previously deducted taxes are includible in the gross income of the recipient under the tax benefit rule to the extent the recipient benefited from the prior deduction as discussed above. A payor has a reporting obligation under § 6041 only for payments of gains, profits, and income. The proposed refunds must be reported as gains, profits, or income only to the extent the payor has information indicating that the recipient deducted the payment and received a tax benefit.

Payments made to corporations are generally excepted from information reporting subject to the conditions set forth in § 1.6041-3(p)(1). The payor may treat a payee as a corporation if the payor's records contain an unambiguous expression of corporate status.

Please call (202) 622-4950 if you have any further questions.