IRC Section 61 - Gross Income Defined

IRC Sections 61, 1221
Document Date: February 5, 2002

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224
February 5, 2002
Number: 200211042
Release Date: 3/15/2002
FSA-N-160624-01 lCC: IT&A: 1
UILC: 61.00-00; 61.49-01; 1221.00-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE TECHNICAL ASSISTANCE
MEMORANDUM FOR ASSOCIATE AREA COUNSEL,
SMALL BUSINESS/SELF-EMPLOYED, AREA 5, ST. LOUIS CC:SB:5:STL
FROM: Associate Chief Counsel

(Income Tax and Accounting)

SUBJECT: Sale of Missouri Tax Credits

This Chief Counsel Advice provides a response to your memorandum forwarded by an e-mail dated November 2, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

ISSUES

1. Does a taxpayer realize income with respect to the issuance of a transferable State of Missouri remediation tax credit?

2. What are the tax consequences when the taxpayer sells the tax credit to a third party?

CONCLUSIONS

1. The issuance of the credit, by itself, does not result in gross income to a taxpayer and is not otherwise treated as a payment by the state. If the credit is applied to the taxpayer's state tax liabilities, it will simply reduce the amount of any otherwise allowable deduction for state tax liabilities.

2. The taxpayer has no basis in the credit. Therefore, the gain is equal to the amount realized. The gain is ordinary gain, because the credit is not "property" for purposes of § 1221.

FACTS

The State of Missouri offers a number of incentives and assistance for the redevelopment of commercial and industrial sites abandoned due to contamination caused by hazardous substances.

The Missouri Department of Natural Resources (DNR) administers a voluntary clean-up program(VCP). The VCP provides oversight to property owners (and other persons having an interest in a piece of property) who want to clean up hazardous substance releases. Under the

VCP, if a property owner complies with DNR's requirements, DNR will issue a Certificate of Completion or a No Further Action Letter (a "clean letter") at the completion of the project.1 This program provides some limited liability to the property owner against future claims related to environmental contamination. See generally §§ 260.565 to 260.575 Mo. Ann. Stat. (West 2001).Participation in the VCP is a prerequisite to participation in Missouri's Brownfield Redevelopment Program.

The Missouri Department of Economic Development (DED) administers the Brownfield Redevelopment Program. The purpose of this program is to provide assistance and incentives for the redevelopment of commercial and industrial sites abandoned or underutilized due to contamination caused by hazardous substances. See generally §§ 447.700 to 447.718 Mo. Ann.Stat. (West 2000).

As part of the Brownfield Redevelopment Program, subsection 3 of § 447.708 provides for a remediation tax credit for up to 100 percent of the costs of materials, supplies, equipment, labor,professional engineering, consulting and architectural fees, permitting fees and expenses,demolition and asbestos abatement, and direct utility charges for performing voluntary remediation activities for preexisting hazardous substance contamination and releases. These costs include the costs of performing operation and maintenance of the remediation equipment at the property beyond the year in which the systems and equipment are built and installed at the eligible project, and the costs of performing the voluntary remediation activities over a period not in excess of four tax years following the year in which the system and equipment were first put into use at the eligible project. To qualify, the remediation activities must be the subject of a plan approved by the DNR.2 The credit does not include any costs associated with ongoing operational environmental compliance of the facility or remediation costs arising out of spills, leaks, or other releases arising out of the ongoing business operations of the facility.

The credit is limited to the lesser of: (1) the eligible costs, (2) the economic benefit to the state from the clean-up project, or (3) the amount necessary to induce the owner to proceed with the project, as determined by the DED.

Subsection 3 of § 447.708 provides that no more than 75 percent of earned remediation tax credits may be issued when the remediation costs are paid, and the remaining percentage may be issued when the DNR issues a "clean letter." Subsection 8 of § 447.708 provides that taxpayers claiming the remediation tax credit are required to file all applicable tax credit applications,forms, and schedules during the taxpayer's tax period immediately after the tax period in which the eligible project was first put into use, or during the taxpayer's tax period immediately after the tax period in which the voluntary remediation activities were performed. It is our understanding that the practice in Missouri is a "claim as you go" standard; in other words, a claim for a remediation tax credit can be made and often is made in the year of the expenditure.

The remediation tax credit can be used to offset the state income tax (excluding the withholding tax), corporation franchise tax, or financial institution tax. The remediation tax credit may be taken in the same tax year in which it is received or it may be taken over a period not to exceed twenty years. Subsection 3 of § 447.708 Mo. Ann. Stat. In the case of a taxpayer that is a partnership or an S corporation (as defined in § 1361 (a)(1) of the Internal Revenue Code), the remediation tax credit is-allowed to the partners of the partnership or the shareholders of the

S Corporation in proportion to their share of ownership. Subsection 11 of § 447.708 Mo. Ann.Stat.

The recipient of a remediation tax credit may assign, sell, or transfer (in whole or in part) the credit to any other person. To perfect the transfer of a credit, the original recipient files a form with the DED. The DED then issues a new certificate to the credit transferee. The number of tax periods during which the transferee may subsequently claim the credit shall not exceed twenty

tax periods, less the number of tax periods the transferor previously held the credit before the transfer occurred. Subsection 9 of § 447.708 Mo. Ann. Stat.

There is a market for the transfer of remediation and other transferable tax credits. Based on information provided to the Service, the market price generally reflects between 80 to 90 percent of the face amount of the credit. It is our understanding that there are brokers who facilitate the market.

LAW AND ANALYSIS

1. Issuance of credit.

Section 61(a) of the Code provides generally that gross income means all income from whatever source derived, except as otherwise provided in subtitle A. Section 1.61-1(a) of the Income Tax Regulations provides, in part, that gross income means all income from whatever source derived,unless excluded by law. Gross income includes income realized in any form, whether in money,property, or services.

Generally, a state tax credit, to the extent that it can only be applied against the recipient's current or future state tax liability, is treated for federal income tax purposes as a reduction or potential reduction in the taxpayer's state tax liability. The amount of the credit is not included in the taxpayer's federal gross income, or otherwise treated as a payment from the state,3 and is not deductible as a payment of state tax under § 162 or § 164. Cf. Rev. Rul. 79-315, 1979-2 C.B. 27,Holding (3) (IoWa income tax rebate). Similarly, an accrual-basis taxpayer is not required to take the value of such future tax credits into income; the credits will simply reduce the taxpayer's otherwise-deductible tax liabilities as, and if, they accrue. See Snyder v. United States, 894 F.2d1337 (6th Cir. 1990).4

A similar approach generally applies in the case of a refundable state tax credit--that is, a credit that is paid to the taxpayer as a "refund" to the extent it exceeds tax liability.5 Refundability does not cause the entire credit to be treated as a payment by the state. Instead, the portion of the credit that is applied to reduce tax is still treated as a reduction in tax; only the portion that is actually refunded is treated as a state payment, includable in income unless some other exclusion applies.

The Missouri remediation tax credit differs somewhat from the types of state credits described above because it is transferable; it may be applied against one of several state taxes or, at the taxpayer's option, transferred for value in a functioning market. Since transferability is one attribute of property, this feature suggests that the issuance of the credit should be treated, for federal income, tax purposes, as the receipt from the state of property--the fair market value of which, assuming no exclusion applies, would be includable in income.6 In our view, however, the existence of the right of transferability, without more, does not change the tax treatment relative to the other types of state tax credits described above.Accordingly, the remediation tax credit retains its character as a reduction or potential reduction in state tax liability, unless and until it is actually sold to a third party.7

The receipt and use of the remediation tax credit by the original recipient can be illustrated by the following example. Assume that during Year 1 a cash-basis taxpayer receives a credit of $50x.Further, assume that the taxpayer uses the entire credit to offset a state income tax liability of$80x, either in Year 1 or a later year. In this scenario, the taxpayer has incurred and paid only$30x of state taxes and therefore could deduct only $30x under § 162 (or perhaps § 164),assuming the payment otherwise qualified for the deduction. The taxpayer has no income with respect to the receipt of the $50x credit in any year. Similarly, the credit is not treated as a

reimbursement, and has no effect on the federal tax treatment of the remediation expenditures upon which it is based.

2. Sale of credit to a third party.8

a. Gain from disposition of credit.

Section 1001(a) provides that the gain from the sale or other disposition of property shall be the excess of the amount realized over the adjusted basis provided in section 1011, and the loss shall be the excess of the adjusted basis over the amount realized. Section 1001(b) defines the amount realized from the sale or other disposition of property as the sum of any money received plus the fair market value of any property received. Section 1001(c) provides that, except as otherwise provided in subtitle A of the Gode, the entire amount of the gain or loss on the sale or exchange of property shall be recognized. See also § 1.1001-1(a).

If a taxpayer who received a remediation tax credit transfers all or a portion of the credit for value, the transaction is a disposition of the credit under § 1001. Initially, to determine the amount of any gain, we must determine what amount is used as the credit's basis. Section 1012provides generally that the basis of property shall be the cost of the property. Section 1.1012-1(a)defines cost to be the amount paid for the property in cash or other property. The taxpayer paid nothing for the credit, and the taxpayer has no "tax cost basis" in the credit because it was not previously includable in gross income when the credit was issued. Consequently, the credit has azero basis, and the gain equals the amount realized. The taxpayer's gain is consideration received from a third party for the transfer of the credit; it is not a reimbursement or partial reimbursement of the costs upon which the credit was originally based, and is not excludable from income.9

b. Character of gain.

Generally, in order for gain to qualify as capital gain, the transaction must involve the "sale or exchange," as defined in § 1222, of a "capital asset," as defined in § 1221. In addition, in order to qualify for favorable long-term capital gains rates, under § 1222 the asset must have been held for more than one year.10

Section 1221 defines the term "capital asset" as property held by the taxpayer, regardless of the taxpayer's trade or business, unless the property meets one of eight listed exceptions. Section1.1221-1(a) states, "The term 'capital assets' includes all classes of property not specifically excluded by section 1221."

In the present case, none of the listed exceptions in § 1221 appears to apply. However, despite §1221's apparent broad definition of capital asset, the Supreme Court has stated "it is evident that not everything which can be called property in the ordinary sense and which is outside the statutory exclusions qualifies as a capital asset"; rather, "the term 'capital asset' is to be construed narrowly in accordance with the purpose of Congress to afford capital-gains treatment only in situations typically involving the realization of appreciation in value accrued over a substantial period of time, and thus to ameliorate the hardship of taxation of the entire gain in one year."Commissioner v. Gillette Motor Transport, Inc., 364 U.S. 130, 134 (1960) (citing Burnet v.Harmel, 287 U.S. 103, 106 (1932)). Accordingly, the Court has held that certain interests that are concededly "property" in the ordinary sense are not capital assets. Id.; Hort v. Commissioner, 313 U.S. 28 (1941) (unexpired lease);Commissioner v. P.G. Lake, Inc., 356 U.S. 260 (1958) (oil payment rights)."

In determining whether certain intangible rights should be considered "property" within the meaning of sections 1221 and 1231, the courts have considered a variety of factors, including how the rights originated or were acquired; whether the rights were treated as property for federal

tax purposes when acquired; whether the rights are incident to, or create an estate in, specific real or personal property that is itself a capital asset; whether the rights represent income already earned or about to be earned; whether the rights can appreciate in value over a period of years asthe result of market forces; whether significant investment risks are associated with the transferred rights and included in the transfer; whether a market and a market price exists for the rights; whether the transfer merely substituted the source from which the taxpayer otherwise would have received ordinary income; whether the rights primarily represented compensation for past or future personal services; whether the taxpayer parted, with the totality of its rights, or"carved out" a portion in some fashion; and whether it is possible to assign a specific basis to the transferred rights. No single factor or group of factors is dispositive.12

A taxpayer who sells a remediation tax credit has parted with all rights in the credit. However, as discussed above in connection with its original issuance, the credit, even though it is transferable,primarily represents the right to a reduction or potential reduction in the holder's tax liability. It is not incident to, and does not create an estate in, property that is itself a capital asset. While it does not represent compensation for specific services, it was issued as an incentive for the recipient to engage in remediation activities. Moreover, in that sense it has already been "earned":unlike a right the value of which depends on further exploitation by the holder, the only substantial contingency preventing realization of the value of the remediation tax credit is that the holder (or a potential transferee) incur a tax liability against which it can be applied.Although the credit is not a right to a stream of ordinary income, it is a right to reductions in tax payments normally deductible from ordinary income. As a transferable asset, the credit has a certain market value that may fluctuate over time; however, as a credit against a state tax liability, it does not appreciate or depreciate and can be used at any time for its stated amount by any holder with a tax liability. Finally, the original issuance of the credit was not treated for federal tax purposes as a transfer of property includable in the recipient's income; the recipient has no "tax cost" or other basis in the credit, no investment, and no risk of loss. Balancing these factors, we conclude that the remediation tax credit is not property for purposes of § 1221.

Accordingly, the sale of the remediation tax credit by the original recipient results in ordinary gain.

Please call if you have any further questions about these issues.

Associate Chief Counsel

(Income Tax and Accounting)

By

PAUL M. RITENOUR

Chief, Branch 1

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1 The materials on the state's website mention that the average length of time from receipt of the application to issuance of the "clean letter" is 12 months, and about 75percent of the sites have taken less than 18 months to complete.

2 The director of DED may, with the approval of the director of DNR, extend the tax credits allowed for performing voluntary remediation maintenance activities, in increments of three-year periods, not to exceed five consecutive three-year periods.

3 A payment from the state is not necessarily includable in income. For example,depending on the circumstances, it might be excluded as a general welfare payment, a reimbursement of a deductible expense, a rebate that reduces basis, a contribution to capital under § 118, etc.

4 As this example demonstrates, the fact that excess credits in a given year may be"carried" to other years does not cause the credit to be treated as a payment from the state.

5 The term "refundable" is normally applied to describe such credits, even though the payment is not a refund of something the taxpayer originally paid the state.

6 The taxpayer would then have a "tax cost basis" in the credit equal to its fair market value. Subsequent sale of the credit would result in gain or loss, and use of the credit to reduce tax would be treated as a sale of the credit with the sales proceeds used to pay the tax.

7 We note that we believe the credit does not represent compensation for remediation services performed by the taxpayer. If it did, that might affect our analysis and conclusion. We also do not imply that the result would necessarily be the same if transferability were combined with other features, such as refundability.

8 Note that this discussion concerns the tax treatment of the original recipient of the credit; the federal tax treatment of a credit transferee is beyond the scope of this memorandum.

9 We do not mean to imply that the gain would be excludable from income as a reimbursement. The remediation costs incurred by the taxpayer would generally be capital expenditures, and a non-rebate reimbursement of a capital expenditure is generally includable in gross income. See, e..q., Baboguivari Cattle Co. v. Commissioner, 135 F.2d114 (9th Cir. 1943); Rev. Rul. 84-67, 1984-1 C.B. 28.

10 Presumably, in many cases it will not be significant whether or not the disposition of a remediation tax credit is the sale or exchange of a capital asset, because taxpayers who plan to sell the credit will do so within a year.

11 Accordingly, certain interests can be property for purposes of § 1001 but still not qualify as a capital asset under § 1221.

12 See, e..q., United States v. Dresser Industries, Inc., 324 F.2d 56 (5th Cir. 1963);Commissioner v. Ferrer, 304 F.2d 125 (2d Cir. 1962); Rhodes' Estate v. Commissioner,131 F.2d 50 (6th Cir. 1942); Foy v. Commissioner, 84 T.C. 50 (1985); Estate of Shea v.Commissioner, 57 T.C. 15 (1971), acq., 1973-2 C.B. 3; Guggenheim v. Commissioner,46 T.C. 559 (1966), acq., 1967-2 C.B. 2. Although most of the decided cases involve contract rights, the analysis applies equally here.