Office of Chief Counsel
Internal Revenue Service
Memorandum

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date: August 22, 2012

to: Revenue Agent
LB&I,

from: Associate Area Counsel (LMSB), Chicago

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subject:
Income from Discharge of Indebtedness

Years Under Examination:

In our opinion, the taxpayer in the circumstances given does not report income until the all events test under I.R.C. Sec. 451 is met, no earlier than

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Facts

(the taxpayer) is the sole owner of a subsidiary known as . is a corporation doing business in as a manufacturer of

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The taxpayer considered closing the factory in

and consolidating the business in another state. To discourage this, the State of , on , entered into a contract with whereby the state provided a income tax credit and a loan to . In return, was required to make certain capital improvements (totaling), to retain existing jobs, and to create an additional jobs in as of . These new jobs were required to be full-time positions paying at least $13.00 per hour. If these goals were satisfied as of , the loan and all accumulated interest would not be due as of

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The loan incurred interest at a fixed rate of % per year but none of that interest was payable during the loan term; it all accumulated and was due on .

In the event that , as of , had created fewer than

jobs, the loan would be partially cancelled. In that event, would be obligated to pay the state $, plus interest, for every job short of the goal. For example, if created jobs, it would be jobs short of the goal and the company would be required to pay the state $ ( ) in principal, plus interest. The remainder of the loan would be cancelled. (Note that $ is simply $ divided by .)

reported of the $ as "miscellaneous income" every month from the date the proceeds were received to the present.[1] Upon examination, however, the taxpayer states that the correct treatment would be to report none of the $ as income until the all events test is met ( ). See Memo dated .

Per the agreement, the $ tax credit is not to be allowed until , and as that year is not under examination, we do not provide any advice with regard to that credit.

Issue

Where a taxpayer receives a loan from a state government and the loan, according to its terms, will be wholly or partially cancelled at the end of months, depending on whether the taxpayer has created a specified number of jobs during that time, are the loan proceeds income to the taxpayer when received or when the all events test is met ( ).

Law

I.R.C. Sec. 61(a) provides that gross income includes all income from whatever source derived, including income from discharge of indebtedness. See I.R.C. sec. 61(a)(12).

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[1] Note that years is months. Apparently, expected to receive the loan in and therefore anticipated a -year loan term.

I.R.C. Sec. 451(a) provides the general rule that the amount of any item of 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.

Treas. Reg. Sec. 1.451-1(a) provides accrual method taxpayers with a two-prong "all events" test to determine when income is includible in gross income. The "all events" test provides that income is includible in gross income when: (1) all events have occurred which fix a right to receive such income; and (2) the amount can be determined with reasonable accuracy. All the events that fix the right to receive income generally occur when (1) the taxpayer earns the payment through performance, (2) payment is due to the taxpayer, or (3) the taxpayer receives the payment, whichever happens first. See Rev. Rul. 84-31, 1984-1 C.B. 127.

I.R.C. Sec. 118 states that in the case of a corporation, gross income does not include any contribution to the capital of the taxpayer.

Analysis

Income and Timing

After coordination with the Chief Counsel National Office, and based on the facts and circumstances of this examination, we are of the opinion that the transaction is a genuine loan in both substance and form.

The principal not required to be repaid under the loan agreement is income. Borrowed funds are excludable in the first instance because the taxpayer's obligation to repay the funds offsets an increase in the taxpayer's assets; if the taxpayer is thereafter released from his obligation to repay, the taxpayer enjoys a net increase in assets equal to the forgiven portion of the debt. See U.S. v. Kirby Lumber Co., 284 U.S. 1, 3 (1931).

However, if a taxpayer's obligation to pay a lesser amount is determined under the terms of an instrument that impose the repayment obligation, the taxpayer realizes an accession to wealth, and thus income, although it is not income from "discharge" of indebtedness. See United States v. Centennial Savings Bank FSB, 499 U.S. 573 (1991).

In United States v. Centennial Savings Bank FSB, the United States Supreme Court addressed a bank's income tax treatment of early withdrawal penalties owed to the bank on holders' premature redemption of certificates of deposit. The bank conceded that the early withdrawal penalties were income under I.R.C. Sec. 61(a). However, the bank argued that the early withdrawal penalties owed to the bank, which offset the principal and interest owed to the holders on redemption of certificates of deposit, represented discharge of indebtedness income excludible from gross income under I.R.C. Sec. 108. The Supreme Court found that, because the certificate of deposit agreement itself provided that the depositor was entitled to only the principal and interest, less any early withdrawal penalty, the depositor did not “discharge” the bank of an obligation when the depositor accepts exactly what the bank was obligated to pay under the terms of the CD agreement. Accordingly, the early withdrawal penalties were income, but not discharge of indebtedness income under I.R.C. Sec. 61(a)(12), and, therefore, were not excludable from the bank's gross income pursuant to I.R.C. Sec. 108.

In the present case, we conclude that the principal not subject to repayment is not income from discharge of indebtedness under I.R.C. Sec. 61(a)(12). That section contemplates the discharge or forgiveness of a loan. In this case, the loan agreement itself provides a formula for determining the amount owed, the resulting income that derives from the principal not subject to repayment is simply from an accession to wealth, and includible in income under I.R.C. Sec. 61.

Because the income from the principal not subject to repayment is not income from discharge of indebtedness under I.R.C. Sec. 61(a)(12), the income is not excludable under I.R.C. Sec. 108. See United States v. Centennial Savings Bank FSB.

The taxpayer apparently does not dispute that the loan principal, if cancelled subject to the terms of the loan agreement, is income. At issue is when that income is includible in gross income. Under Reg. Sec. 1.451-1(a), income is includible when all events have occurred to determine the fact of liability and the amount can be determined with reasonable accuracy. Under the terms of the loan agreement, all or part of the obligation to repay the loan definitively ceases to exist as of

, depending upon the number of jobs created and maintained. Thus, under the facts of this case, the two-prong all events test is met no earlier than

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It has been suggested that the above explanation does not apply because the transfer of funds from the state to is not a genuine loan; that the state is simply paying in advance for a service (job creation), and that the state does not expect repayment. Under this theory, the $ payment would be income to the recipient when paid. See United States v. Ingalls, 399 F.2d 143 (5th Cir. 1968). Regarding the "true loan" concept:

> For disbursements to constitute true loans there must have been, at the time the funds were transferred, an unconditional obligation on the part of the transferee to repay the money, and an unconditional intention on the part of the transferor to secure repayment. In the absence of direct evidence of intent, the nature of the transaction may be inferred from its objective characteristics. Geftman v. Commissioner, 154 F.3d 61, 68 (3d Cir. 1998).

Among the objective indicia of loans are a fixed maturity date, a fixed principal sum, periodic interest payments, and a payment schedule. Merck & Co., Inc. v. United States, 652 F.3d 475, 482 (3d Cir. 2011).

In our opinion, the loan is bona-fide, as it has a written loan agreement, principal was transferred, interest was incurred at a given interest rate, and repayment was required in a reasonable period of time. While it is probably true that the state prefers that the loan never be repaid (i.e., it prefers that jobs be created), it is clear that, under the contract, the state has the right to receive repayment, in whole or part (according to the number of jobs created), and there is no indication that the state wouldn't pursue repayment if the taxpayer failed to uphold its end of the bargain. There is no indication that loan cancellation was intended from the beginning, nor that such cancellation was inevitable or even highly probable. The loan is genuine; the circumstances where it might not be repaid (or might not be repaid in full) are contingent.

It is undisputed that the state provided a cash incentive for a corporation to create jobs. The proposed theory for recognizing income in depends on the premise that this incentive is, in substance, "an advance payment for services" disguised as a loan. As stated above, the facts indicate that the loan was genuine in substance as well as in form. Furthermore, we know of no precedent for holding that a cash incentive to create jobs is the "purchase of services," i.e., job creation has not been recognized as a "service." In the absence of such precedent, we do not believe that the theory can be pursued that the transfer of the loan principal was a pre-payment for services to be performed. It is more reasonable to conclude that the creation of jobs is, for the state, an "anticipated future benefit . . . so intangible as to not warrant treating the contribution as a payment for future services." S. Rep. No. 1622, 83rd Cong., 2nd Sess. 18-19 (1954).[2]

Change of Accounting Method

The proposed adjustment involves a change of accounting method. The taxpayer, as mentioned above, reported $

of income pro-rata over sixty months, beginning in (the year the loan was made). Presumably, this allocation of income was also reported in the taxpayer's returns for and (which are not currently under examination). In the course of the examination for , the taxpayer informally requested, and we agree, that the income should be reported when the all events test is met ( ). This is a change from an incorrect method to a correct method of accounting. By delaying the reporting of income, the proposed change works in the taxpayer's favor.

Adjusting the returns to report the entire amount only when the all events test is met is a retroactive change of accounting method. It is a change from an impermissible method to a permissible method. The taxpayer informally requested such a change, but only after the issue of when the income should be reported was raised by the Service in the course of the examination. Under these circumstances, we believe that this should be considered a Service-initiated examination activity as defined in the Internal Revenue Manual. As such, the change can be implemented by the revenue agent without the taxpayer filing a Form 3115 ("Application for Change of Accounting Method") and

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[2] Although the taxpayer has not raised the issue, it may be asked whether the cancellation of the debt would be a contribution to capital by a non-shareholder, rather than income, under I.R.C. Sec. 118. We believe that Sec. 118 does not apply, as the amount of debt to be cancelled depends on the number of employees hired and retained. While this may be considered an operating subsidy, it is clearly not a contribution to capital.

without it being processed through the usual channels. See IRM 4.11.6.7.5(1) and (2); Rev. Proc. 2002-18, 2002-1 C.B. 678.

In any change of accounting method, the goal is to avoid both the duplication and the omission of items of income and deduction. For this taxpayer, income reported in

, and is to be reduced; in order to avoid the omission of that income, it must be reported in a year that has yet to occur. Under such circumstances, a closing agreement (as authorized by I.R.C. Sec. 7121) is strongly advised. This will prevent the taxpayer from taking contradictory positions, such as accepting the reduction of income imposed by the Service in earlier years and then arguing that the income is non-reportable in the later year. If our agreement with the taxpayer is embodied in a closing agreement, it is moot whether the change of accounting method is imposed by the Service or requested by the taxpayer.

Conclusion

Based on the facts and circumstances of this examination, the transfer of $ from the state to the corporation was a genuine loan. If, and only if, the specified number of jobs are created and are in existence as of (as provided in the loan agreement) has the taxpayer fulfilled the necessary conditions to retain all or part of the loan principal. That part of the principal not subject to repayment is an accession to wealth for the taxpayer and thus ordinary income, and not income from the discharge or forgiveness of indebtedness. The income is recognized when the all events test is met, no earlier than

. The cancelled debt is not a capital contribution.

If you have any questions, please contact the undersigned at 414-231-2807.

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By: ______________________________
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