General Counsel Memorandum 39583

The taxpayer in this GCM is a partnership which has been advanced large sums of money from the Department of Energy (DOE) to help in establishing and operating a synthetic fuel producing plant.

ISSUE. Do the sums advanced to the partnership, under a plan which makes repayment to the government subject to several contingencies, constitute gross income under section 61.

CONCLUSION. The Office of Chief Counsel has concluded that the sums of money advanced by the government under a plan making repayment subject to contingencies are not includable in a partnership's gross income.

ANALYSIS. The Service based its reasoning on the terms of the loan agreement governing the partnership's repayment to the DOE. In brief, repayment of the loan was only required if the project to produce synthetic fuel became economical (i.e. profitable with a healthy economic forecast) and if the facility continued to operate as a viable fuel producing plant. The nature of the plant involved and the fuel being produced, concluded the Service, made it 'quite likely [that] such proceeds would never have to be repaid.'

The Service concluded, however, that the amounts received by the partnership constitute 'contingent liabilities' within the basis disallowance scope of Denver & Rio Grande Western R.R. Co. v. United States, 505 F.2d 1266 (Ct. Cl. 1974). As such, the partners will acquire no basis in the assets purchased with the DOE funds except to the extent of the partnership's repayment of the contingent liabilities.

Full Text:

CC:I-304-84

Br4:DMMerrick/ARFraser

Date Numbered: November 25, 1986

Memorandum to:
Peter K. Scott

Associate Chief Counsel (Technical)

Attention: Director, Individual Tax Division

By a memorandum dated November 8, 1984, the Individual Tax Division forwarded the above-captioned request for technical advice for our consideration.

ISSUES

Whether amounts received by a partnership from the Department of Energy (the Agency) to assist the partnership in the production of synthetic *** fuel from *** constitute gross income under section 61 of the Code, or the nontaxable proceeds of a bona fide loan?

CONCLUSION

We conclude that the amounts received by the partnership from the Agency constitute contingent liabilities within the scope of Denver & Rio Grande Western R.R. Co. v. United States, 505 F.2d 1266 (Ct. Cl. 1974).

As such, these proceeds are not includible in the partnership's gross income when received. However, since repayment of these proceeds by the partnership to the Agency is contingent upon (1) the *** production project being 'economical,' and (2) the continued operation of the *** production facility by the partnership, we conclude that such repayment requirement is so contingent, given the nature of the substantial economic risks of this project, that the partnership has not itself incurred costs with respect to, and thus acquires no basis in, the capital assets purchased with such contingent liability proceeds. Thus, the partners will acquire no basis in such assets until, and only to the extent of, the partnership's repayment of such contingent liability proceeds. Similarly, any partnership expenditures for otherwise deductible expense items paid out of such contingent liability proceeds would be nondeductible by the partnership and the partners until, and only to the extent of, the partnership's repayment of such contingent liability proceeds.

FACTS

The taxpayer is an *** general partnership, consisting of partners, organized for the purpose of designing, engineering, building, and operating a *** plant for the production and sale of *** fuel. The partners contributed to the partnership assets totalling *** 1 The plant has been in operation continuously since ***.

Pursuant to the Federal Nonnuclear Research and Development Act of 1974, Pub. L. No. 93-577, section 8, 88 Stat. 1886 (1974) (codified at 42 U.S.C. S 5907), 2 the Department of Energy (the Agency) entered into an agreement *** with the partnership and thereunder advanced to the partnership a total of *** for construction of the plant. Under Article V of that agreement, the partnership's duty to repay and accrue interest on the advances is as follows:

ARTICLE V - REPAYMENT

A. The Participant [partnership] shall, in accordance with the provisions of this Article V, repay to the Government the amount actually paid to the Participant under this Agreement. IF PAYMENT IS CONTRIBUTING TO AN UNECONOMICAL OPERATION OF THE PROJECT DURING THE AGREED REPAYMENT PERIOD, THE GOVERNMENT MAY CONSIDER RENEGOTIATION OF REPAYMENT TERMS.

B. THE TERMS OF REPAYMENT, IF REQUIRED, ARE AS FOLLOWS:

(1) Neither payment of interest nor repayment of principal will be required for the ten (10) years immediately following the effective date of this Agreement.

(2) Interest will not be accrued for the first ten (10) years immediately following the effective date of this Agreement.

(3) Repayment of the GOVERNMENT'S MONETARY CONTRIBUTION to the project will be made in equal yearly amounts over a ten (10) year period beginning on the eleventh (11th) anniversary of this Agreement.

(4) An interest rate of *** or the rate charged from time to time during the repayment period under the Industrial and Business Loan Program of the Farmers Home Administration for [a] project of a similar size, whichever is less, will apply commencing on the tenth (10th) anniversary of this Agreement. Interest due becomes payable at the eleventh anniversary and yearly thereafter.

C. THE OBLIGATION TO REPAY WILL TERMINATE UPON THE TERMINATION OF THIS AGREEMENT PURSUANT TO ARTICLE XII OF THIS AGREEMENT.

D. The Participant shall be permitted at anytime to repay the amount of the GOVERNMENT'S MONETARY CONTRIBUTION, or provide for such prepayment, without penalty. Prepayment in full, or the provision for guaranteed prepayment, by the Participant shall terminate the Participants [sic] obligations thereunder. [Emphasis added.]

Article XII of that agreement provides:

ARTICLE XII - TERMINATION

A. The Contracting Officer or the Participant may terminate this Agreement in whole, or in part, when both parties agree that continuation of the project would not produce beneficial results commensurate with the further expenditure of funds. The two parties shall agree upon the termination conditions, including the effective date and, in the case of partial terminations, the portion to be terminated. The Participant shall not incur new obligations for the terminated portion after the effective date, and shall cancel as many outstanding obligations as possible. The Contracting Officer shall allow credit to the Participant for the DOE share of the noncancelable obligations, properly incurred by the Participant prior to termination. THE PROJECT MAY BE TERMINATED IF IT CAN BE SHOWN THAT IT WILL BE UNECONOMICAL. CONDITIONS WHICH MAY RENDER THE PROJECT UNECONOMICAL and thus liable to termination include, but are not limited to, the following:

(1) Extensive schedule delays which MAKE THE PROJECT UNPROFITABLE.

(2) Severe cost overruns which RENDER THE PROJECT UNPROFITABLE.

(3) Changes in Federal or State regulations which SEVERELY AFFECT PROJECT

ECONOMICS.

(4) Inability to obtain the necessary permits or licenses.

B. The Contracting Officer may terminate the Agreement in whole, or in part, at any time before the date of completion, whenever it is determined that the Participant has substantially failed to comply with the material conditions of the Agreement and such failure is of a substantial and material nature. The Contracting Officer shall promptly notify the participant in writing of the determination and the reasons for the determination, together with the effective date of termination if the participant does not resume compliance with the conditions of the Agreement. The Participant shall have a 60-day period after notification in which to cure a failure to comply.

C. WITH THE CONCURRENCE OF THE GOVERNMENT, THIS AGREEMENT SHALL TERMINATE UPON THE PERMANENT CESSATION OF OPERATIONS BY THE PARTICIPANT.

Thus, under the subject agreement between the Agency and the partnership, no interest accrues on the advance between *** nor are there to be any repayments of principal during that period. Repayment of principal is to be made in equal yearly amounts between ***Between *** interest is to accrue and be paid annually, starting in *** at the lesser of *** or the current interest rate of a certain program of a designated federal agency.

The Agency advanced approximately *** to the partnership in *** and the balance (less a small retainage) of the *** in the following *** year. The advanced proceeds were not included in the partnership's gross income, but were treated by the partnership as a loan. Expenditure of these proceeds by the partnership was in part deducted (for expense items) by the partners and in part capitalized (for capital asset acquisitions) by the partnership. The partnership claimed a cost basis in the capital assets acquired with those funds, and sought to distribute to the partners their respective distributive shares of the depreciation and energy and investment tax credits attributable to the amounts capitalized.

ANALYSIS

Section 61 of the Code defines gross income as all income from whatever source derived, unless excluded by law. See Treas. Reg. section 1.61-1(a).

Section 1012 of the Code provides that the basis of property shall be the cost of such property, except as otherwise provided in the Code.

The primary issue in the subject case is whether the proceeds paid by the Agency to the subject partnership constitute gross income to the partnership in the year received, or whether such proceeds constitute a loan by the Agency to the partnership. The partnership asserts that it was not in receipt of gross income in the subject case because the proceeds it received from the Agency constituted a loan.

The partnership further contends that any partnership expenditures of such proceeds are to be added to the partnership's basis in the ***production facility (or deducted to the extent any of such expenditures would otherwise be properly treated as deductible expenses). The partnership concedes that it would be in receipt of discharge of indebtedness income when and to the extent the loan is cancelled or forgiven. The revenue agent, on the other hand, contends that such proceeds, as a technical matter, are gross income to the partnership in the year received by it because repayment of such proceeds is subject to the substantial contingencies of (1) the project being economical and (2) the partnership's continued operation of the plant. The agent, however, suggests the possible application of the section 621 exemption for amounts paid by the federal government to fund development of critical and strategic minerals or metals.

We begin our analysis recognizing that the section 61 gross income definition is intended to be an all-inclusive one. See Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955). In this context, the Court in Glenshaw Glass stated that it was 'the intention of Congress to tax all gains except those specifically exempted.' Id. at 430. On the other hand, it is clear that loan proceeds do not constitute gross income (an accession to wealth) to the recipient (borrower). See Anson Beaver v. Commissioner, 55 T.C. 85, 91, (1970), in which the Tax Court stated that the 'question whether a debtor- creditor relationships is created at the time an [amount] is received is a question of fact to be determined upon a consideration of all the evidence.'

For the reasons set forth below, and upon consideration of all the evidence in the subject case, we believe that the agreement entered into between the Agency and the partnership does establish the existence of an excludable debt obligation running from the partnership to the Agency at the time the proceeds are paid by the Agency to the partnership. However, we believe such debt obligation is a contingent liability that comes within the basis disallowance scope of Denver & Rio Grande Western R.R. Co. v. United States, 505 F.2d 1266 (Ct. Cl. 1974). his is because we conclude that the repayment of the proceeds in issue was so contingent upon (1) the project being economical, and (2) the continued operation of the *** production facility by the partnership, that it was quite likely such proceeds would never have to be repaid.

The partnership asserts that the profitability contingency is not absolute, but is rather at most a condition subsequent that might terminate an otherwise valid loan obligation some time in the future if and when the plant's unprofitability negates or reduces the partnership's repayment of the proceeds to the Agency. The partnership asserts that such condition subsequent (the ability of the Agency to cancel the partnership's obligation to repay under Article XII of the agreement) is nothing more than any creditor's right to cancel the borrower's obligation. The partnership further asserts that the Agency, which paid the proceeds to the partnership, viewed the transaction as a loan to be repaid by the partnership. The Agency has so stated in an *** memorandum submitted in connection with the subject case.

The partnership further argues that even if its obligation to repay the proceeds to the Agency were considered conditional as a result of the termination provisions in Article XII of the agreement, such fact without more would not result in the failure of the proceeds in issue to qualify as a loan, citing Saunders v. Commissioner, 720 F.2d 871, 873 (5th Cir. 1983). We would agree with this assertion by the partnership where the contingency surrounding repayment was insubstantial, but we think that, as in Saunders, the possibility of forgiveness or cancellation of repayment of the proceeds in the subject case is more than insubstantial or a 'mere contingency.'

The partnership also cites *** G.C.M. 37160, 1-440-76 (June 14, 1977), for the following proposition:

Prearranged conditions of cancellation do not always invalidate a loan for federal income tax purposes. For example, loans to a medical student under a State's Medical Education Loan Scholarship Program that are forgiven if the recipient practices medicine for five years in a rural area are valid loans for federal income tax purposes. Rev. Rul. 73-256, 1973-1 C.B. 56.

We agree that substantial contingencies, which may very well terminate the borrower's express written requirement to repay loan proceeds, as in the subject case, generally do not negate the existence of the loan for purposes of determining whether the purported borrower has gross income in the year the loan proceeds are received. 3

However, recognizing that whether the furnishing of proceeds to the partnership by the Agency is determined to be a loan is not totally free from doubt, we think the Service should be prepared to make an alternate inconsistent argument (in litigation if necessary) that the subject taxpayer is in receipt of gross income in the year of its receipt of the proceeds. See ***G.C.M. 38944, I-275-82 (Dec. 13, 1982), which concludes that section 118 of the Code and the above- cited nonshareholder contribution to capital cases do not apply to amounts received by a partnership from the U.S. government. That GCM holds that such amounts are gross income to the partnership under the broad reach of section 61, citing Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955).

However, we conclude that such substantial repayment contingencies as are present in the subject case, and as were present in Denver & Rio Grande Western R.R. Co. v. United States, supra, do preclude the borrower (the partnership in the subject case) from obtaining any basis in the capital assets it purchased with such proceeds. This, in turn, would prevent any depreciation deduction and energy and investment tax credit from being allowed with respect to such assets to the extent of their purchase with such proceeds.

In Denver & Rio Grande Western R.R. Co. v. United States, supra, the Court of Claims considered the taxpayer railroad's claim that is (sic) was entitled to depreciation and the investment tax credit for a 39-mile spur line that was built to serve the Texas Gulf Sulphur Company's potash mine near Moab, Utah.

The construction of that spur line was almost entirely paid for by funds provided to the taxpayer by Texas Gulf Sulphur under an agreement that required the railroad, after the movement of 100,000 net tons of potash each year on that line, to repay Texas Gulf Sulphur to the extent of 32 percent of its revenue accrued on that line within the first ten years of its operation.

The railroad claimed both depreciation and the investment tax credit with respect to the capitalized construction costs associated with the spur line. The Service disallowed both depreciation and the credit on the ground that the taxpayer's repayment obligation was highly contingent and might never be satisfied.

The taxpayer argued that in light of the facts and circumstances surrounding the transaction, 'it could be predicted with 'reasonable certainty' that the advances made by TGS would be repaid in full.' Id. at 1270.

The Court of Claims did not agree, denying the taxpayer's depreciation deduction and investment tax credit because of the highly contingent nature of the taxpayer's repayment obligation. The court noted with approval an analogous result reached by the Tax Court in the similar case of Denver & Rio Grande Western R.R. Co. v. United States, 32 T.C. 43 (1959), aff'd on other issues, 279 F.2d 368 (10th Cir. 1960), involving railroad sidings financed under a substantially similar agreement with a shipper. The Court of Claims approved of the Tax Court's reliance on Detroit Edison v. Commissioner, 319 U.S. 98 (1943), in which unrefunded deposits exacted by a utility from its customers for the extension of electrical facilities to them were held not to be a part of the taxpayer's basis in such facilities because basis is dependent on 'cost to the taxpayer.' 505 F.2d at 1271, quoting Detroit Edison v. Commissioner, 319 U.S. at 102.

We believe that the Court of Claims' decision in Denver & Rio Grande is dispositive of the subject partnership's claim regarding its entitlement to basis for the Agency-provided proceeds expended for in its *** production facility, both for depreciation and investment and energy tax credit purposes. Such proceeds expended by the partnership to acquire capital assets are not costs of the partnership, and thus are not included in the partnership's basis for depreciation or credit purposes.

We consider the facts in this case, given the nature of the substantial economic risks of establishing a profitable production facility, to warrant the conclusion that the repayment of the proceeds by the partnership to the Agency represents a highly contingent liability. We think Articles V and XII, when read together, provide for the postponement of any repayment for the first ten years of the agreement and make repayment during the remaining ten years of the agreement contingent upon the profitability of the specific *** production facility operated by the partnership. Such a repayment contingency based on profitability is substantial in the subject case because of the highly uncertain and experimental nature of economical *** production.

The Agency was aware, as was the partnership, of the relatively high risk involved in determining whether *** production was commercially feasible, and we think this is why the Agency gave the partnership express assurances in its agreement with the partnership that if such venture was unprofitable, the Agency would 'consider renegotiation of the repayment terms.' Article V A of the agreement. In this same vein, Article V B provides that '[t]he terms of repayment, IF REQUIRED, are as follows.' (Emphasis added). Article V B(3) is written in terms of '[r]epayment of the Government's monetary CONTRIBUTION to the project.' (Emphasis added). Article V D uses the same 'monetary contribution' terminology. This is certainly not unconditional loan terminology. Article V C provides that the 'obligation to repay will terminate upon the termination of this Agreement pursuant to Article XII of this Agreement.' Article XII A expressly provides for termination of the project 'if it can be shown that it will be uneconomical.' Article XII C provides that '[w]ith the concurrence of the Government, this Agreement shall terminate upon the permanent cessation of operations by the [partnership].

We think that the above-quoted provisions provide for the substantial possibility of the Agency's termination of the agreement, and thus the termination of the partnership's obligation to repay the proceeds advanced by the Agency. We would characterize the repayment liability of the partnership in this case as being highly contingent, given the risky business nature of the production venture involved. 4 See Rev. Rul. 80-235, 1980-2 C.B. 229, and Gibson Products Co. v. United States, 637 F.2d 1041 (5th Cir. 1981), aff'g 460 F. Supp. 1109 (N.D. Tex. 1978), both of which hold that nonrecourse liabilities payable out of net profits from synthetic fuel production and oil and gas production, respectively, are so speculative as to create a contingent liability that cannot be included in the basis of property. See also Rev. Rul. 78-29, 1978-1 C.B. 62, and Rev. Rul. 77- 110, 1977-1 C.B. 58, both of which involve nonrecourse liabilities not included in basis. After citing Denver & Rio Grande, Rev. Rul. 80-235 goes on to state:

The Court of Appeals for the Third Circuit, in Pierce Estates v. Commissioner, 195 F.2d 475 (3d Cir. 1952), indicated that a liability is contingent if it is dependent upon the happening of a subsequent event, such as the earning of profits.

See also Albany Car Wheel Co. v. Commissioner, 40 T.C. 831, aff'd per curiam, 333 F.2d 653 (2d Cir. 1963), which held that a company's severance pay obligation, based on the company's failure to give a certain amount of notice to its employees in the event of a plant closing, was too contingent to be included in basis.

Although we conclude that the subject partnership may not include the cost it incurred in purchasing capital assets with proceeds provided by the Agency in its basis of such assets, we believe that, consistent with Denver & Rio Grande, the partnership may build basis in such assets purchased with such Agency proceeds if, when, and to the extent that the partnership makes repayment of such proceeds to the Agency. 5

With respect to any otherwise properly deductible expenses paid by the partnership out of the proceeds provided by the Agency under the subject agreement, we think such deductions should be disallowed for much the same reason as the basis disallowance discussed above. That is, such expenses were not "costs to the partnership," as discussed in Denver & Rio Grande and Detroit Edison. The Agency proceeds out of which such expenses were paid by the partnership were never included in the partnership's gross income, nor were they excludable gifts to the partnership. Thus, we think such expenses are not deductible expenses of the partnership under the contingent liability circumstances of the subject case. Like the allowance of basis, however, if, when, and to the extent of repayment of the proceeds by the partnership to the Agency, we think that the subject partnership should be allowed a deduction in the year of repayment for the otherwise allowable expenses not allowed as deduction in the years prior to repayment. However, we wish to emphasize that no portion of any partnership repayment can be used by the partnership to support both a previously disallowed deduction and an increase in the partnership basis. We think the choice, if and when it becomes available, is the partnership's.

Notwithstanding our no expense deduction conclusion above, for administrative convenience the Service will assume, in the absence of a clear showing to the contrary, that the amounts received by the partnership from the Agency were spent to acquire capital assets. Thus, we recommend that, rather than disallow deductions, the Service first reduce the partnership's basis in its assets following the method of property basis reduction provided in Treas. Reg. 1.362-2. It should be noted that we are not applying section 362(c) to the partnership, but rather we are using the rules thereunder to provide a method of property basis reduction for purposes of implementing the no basis portion of our contingent liability conclusion.

The results we have reached in this case--no income, no basis, and no deduction--are consistent with the results that would be reached were the subject proceeds to be viewed as exempt federal government payments for the development of critical and strategic minerals or metals under section 621 of the Code. That section provides:

THERE SHALL NOT BE INCLUDED IN GROSS INCOME ANY AMOUNT PAID TO A TAXPAYER BY THE UNITED STATES (or any agency or instrumentality thereof), WHETHER BY GRANT OR LOAN, AND WHETHER OR NOT REPAYABLE, for the encouragement of exploration, development, or mining of critical and strategic minerals or metals pursuant to or in connection with any undertaking approved by the United States (or any of its agencies or instrumentalities) and for which an accounting is made or required to be made to an appropriate governmental agency, or any forgiveness or discharge of any part of such amount. ANY EXPENDITURES (OTHER THAN EXPENDITURES MADE AFTER THE REPAYMENT OF SUCH GRANT OR LOAN) ATTRIBUTABLE TO SUCH GRANT OR LOAN SHALL NOT BE DEDUCTIBLE BY THE TAXPAYER AS AN EXPENSE NOR INCREASE THE BASIS OF THE TAXPAYER'S PROPERTY EITHER FOR DETERMINING GAIN OR LOSS ON SALE, EXCHANGE, OR OTHER DISPOSITION OR FOR COMPUTING DEPLETION

OR DEPRECIATION, BUT ON THE REPAYMENT OF ANY PORTION OF ANY SUCH GRANT OR LOAN WHICH HAS BEEN EXPENDED IN ACCORDANCE WITH THE TERMS THEREOF SUCH DEDUCTIONS AND SUCH INCREASE IN BASIS SHALL TO THE EXTENT OF SUCH REPAYMENT BE ALLOWED AS IF MADE AT THE TIME OF SUCH REPAYMENT. [Emphasis added.]

We conclude that the subject *** production does not come within the "mineral or metal" scope of section 621 because *** is *** substance derived from *** that is not a *** "mineral" (usually a naturally occurring inorganic substance) or a "metal" (usually a solid at ordinary room temperatures). Webster's Third New International Dictionary 1437, 1419 (1961). We also question whether *** production can be properly characterized as "critical and strategic" for defense purposes at this point in time.

James F. Malloy
Director
By:
ALAN R. FRASER
Technical Assistant
to the Director
Interpretative Division
Attachment:

Admin. file

1. The partnership's supplementary submission *** indicates that the partners' aggregate contribution to the partnership has ***.

2. In the Federal Nonnuclear Research and Development Act of 1974, Congress authorized the Administrator of the Energy Research and Development Administration to identify opportunities to accelerate the commercial applications of new energy technologies, and provide federal assistance for, or participation

in, demonstration projects (including pilot plants demonstrating technological advances and field demonstrations of new methods and procedures, and demonstrations of prototype commercial applications for the exploration, development, production, transportation conversion, and utilization of energy resources), and to enter into cooperative agreements with non-federal entities to demonstrate the technical feasibility and economic potential of energy technologies on a prototype or full-scale basis. This authority was subsequently transferred to the Secretary of Energy.

3. The partnership's supplementary submission asserts that even if the proceeds furnished to the partnership by the Agency in the subject case do not constitute a loan, then such proceeds constitute a nonshareholder contribution to capital within the meaning of Edwards v. Cuba Railroad Co., 268 U.S. 628 (1925). However, we believe that such a nonshareholder subsidy characterization of such proceeds is untenable on the subject facts because of the partnership's express contingent repayment obligation that precludes viewing such proceeds as a permanent part of the partnership's capital structure. See United States v. Chicago, Burlington & Quincy Railroad Co., 412 U.S. 401, 413 (1973), which, in part, sets forth some of the characteristics of a nonshareholder contribution to capital; see also *** G.C.M. 37354, I-155-77 (1977), to the same effect. Thus, we conclude that the partnership's reliance on Cuba Railroad, Brown Shoe Co. v. Commissioner, 339 U.S. 583 (1950), and CB&Q is misplaced.

4. We note that the partnership's supplementary submission focuses on the economic viability of the ***production venture, based on the favorable economic analyses and predictions on which the Agency proceeds were advanced. However, we conclude that these predictions, no matter how favorable, do not overcome the substantial repayment contingencies (reflecting the risky prototype business nature of the subject venture) that are evidenced in the above-quoted contingent repayment provisions contained in partnership's agreement with the Agency. Simply stated, the subject partnership's repayment obligation under the

Agency agreement is unquestionably contingent and by no means certain. As the court inDenver & Rio Grande stated, "[a]bsent a BINDING OBLIGATION on the Railroad's part to repay all of TGS'advances at the time the investment credit and depreciation deductions were taken, we deem it impossible to value the obligation assumed." 505 F.2d at 1270. (Emphasis added).

5. No opinion is expressed on the issue of the character (principal or interest) of repayments of the loan proceeds if and when they are made by the partnership to the Agency. Such repayments may be recharacterized under the final original issue discount regulations dealing with contingent payment loans.