The Continuing Saga of Non-Taxable Grants, Incentives, and Inducements

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John Geracimos
KPMG LLP
Washington, D.C.

James Atkinson
KPMG LLP
Washington, D.C.

Donald Susswein
McGladrey
Washington, D.C.

Grant receipt:
Taxable unless exception applies

Gross income means all income, from whatever source derived. – Section 61

“All income” has been broadly interpreted to include all undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion. – Glenshaw Glass, S.Ct. (1955)

Therefore, unless an exception applies, the receipt of grant funds is TAXABLE.
Exceptions to grant taxation

Specific legislative exception:
*E.g.*, Renewable Energy Grants
Section 1104 of ARRA amends section 48 of the Code
NOT TAXABLE.

General legislative/case-law exception:
Section 118 non-shareholder contribution to capital
ONLY available for corporations
Many requirements

*Freedom Newspapers* characterization
Treatment of grant receipt as purchase price adjustment

Contribution-to-capital exception

Corporation does not include amount received as CtC in gross income.
Section 118(a)

Includes CtC by a non-shareholder (a “NSCtC”).

Special rules for basis to the corporation – section 362(c)
- Property received in a NSCtC – zero basis
- Property purchased with grant $ w/in 12-months – zero basis
- If all of grant funds not used w/in 12-months – corp must reduce basis in other assets

NOTE – the grant recipient MUST be a corporation
NSCtC Administrative Safe Harbors

Smart Grid Investment Grants -- Rev. Proc. 2010-20
Broadband Initiatives Program and Broadband Technology Opportunities Program grants -- Rev. Proc. 2010-34
Electric Drive Vehicle Battery and Component Manufacturing Initiative grants -- Rev. Proc. 2010-45
Supplemental Discretionary Grants for Capital Investments in Surface Transportation and National Infrastructure Investments grants -- Rev. Proc. 2010-46

NSCtC Exception: Generally

*Detroit Edison*, 319 U.S. 98 (1943)
*Brown Shoe Co.*, 339 U.S. 583 (1950)


1. Transferor intent: did transferor intend to make a NSCtC?
2. Transferee corporation’s use (the Five Factors):
   (i) Become a permanent part of the corporation’s working capital;
   (ii) Not be compensation for specific goods or services;
   (iii) Be bargained for;
   (iv) Benefit to the corporation commensurate with value; and,
   (v) Be employed in, or contribute to, the production of income.
Significance of the Five Factors?

Some recent decisions have questioned the relevance of the Five Factors, observing that the Supreme Court in *CB&Q* acknowledged that the Five Factors were merely “some of the characteristics” of a NSCtC.


On the other hand, on the appeal of *AT&T*, the Fifth Circuit continued to apply the Five Factors.

In particular, the Fifth Circuit’s interpretation of the “bargained for” factor is troubling in that it concluded that “bargaining” requires mutual negotiation or haggling. Specifically, the Fifth Circuit rejected lobbying for legislation as activity that would satisfy the bargained-for factor (“The company sought only to influence the governmental entities’ unilateral decision-making, not to engage in a mutual exchange of commitments.”).

NS CtC Exception: applying the test

Very factual inquiry:

- Stated purposes of underlying legislation
- Nature of benefit to the transferor
- Permitted uses of funds
- Nature of the grant process
  - Competitive? Negotiated?
- Corporation’s uses for the funds
  - Operating expenses? Capital assets?
  - Supplemental income?
- Nature of benefit to the corporation
NSCtC Exception – Certainty?

Request a private letter ruling from the Service
See, e.g., PLR 201003005 (Oct 22, 2009)
Only protects TP making request

Petition for general guidance
See, e.g., Notice 2010-20
No certainty whether the Service will issue guidance

Independently undertake analysis/obtain tax opinion

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James Brown

*James Brown v. Commissioner*, 10 B.T.A. 1036 (1928). Majority shareholder sought to induce “friendly” party to purchase stock from minority shareholder to keep the shares in friendly hands. The majority shareholder was unrelated to either the buyer or the seller. The court held that the payment was made in furtherance of an understanding between the majority shareholder and the buyer under which the buyer acquired the shares at an acceptable purchase price, and so was a purchase price adjustment rather than taxable income.

Freedom Newspapers

*Freedom Newspapers, Inc. v. Commissioner*, T.C. Memo 1977–429. Broker sought to induce potential purchaser to acquire three newspaper companies. The potential purchaser only wanted two of the newspapers, but the seller would only sell the three companies as a package. To induce the sale and receive its commission, the broker agreed to pay the purchaser $100,000 if it was not able to resale the unwanted newspaper on acceptable terms within a year. When it failed to do so, the broker paid $100,000 to the purchaser. The court held that the $100,000 was a reduction in the buyer’s purchase price rather than taxable income.
**General Motors**

*General Motors Corp. v. Commissioner,* 112 T.C. 270 (1999). In order to increase its sales volume during a period of high consumer interest rates, GM sought to offer below-market financing to consumers purchasing its vehicles. Because GMAC was reluctant to absorb the cost of offering below-market interest rates, GM agreed to make rate-support payments equal to the difference between the face amount of the notes paid by GMAC to GM dealers originating the loans, and what GMAC would have paid for the below-market notes in the absence of the agreement with GM. In discussing how the consolidated return regulations applied to these payments, the parties agreed that the rate-support payments were not included in GMAC’s income, but instead reduced its basis in the notes acquired from the dealers. Citing Freedom Newspapers and *James Brown,* the Tax Court stated the payments induced GMAC to enter into a transaction that would otherwise have been financially unattractive.

**Rev. Rul. 2008-26**

Pharmaceutical company was required by the federal government to pay rebates to state Medicaid agencies whenever the agencies reimbursed retailers for drugs dispensed to Medicaid beneficiaries. The IRS ruled that because the rebate is a factor used in setting the actual selling price, negotiated and agreed to before the manufacturer sold the drug to a wholesaler, it was a purchase price adjustment for purposes of determining the manufacturer’s gross receipts.
Rev. Rul. 2006-27

The IRS considered scenarios in which a non-profit organization helped qualified individuals purchase new homes by paying all or part of the required down payment. In one scenario, the payments by the charities were funded with broad-based contributions having no connection to particular home sales. In a second scenario, the down payments largely were funded by amounts collected by the charity from the home sellers and real-estate related businesses that stood to benefit from the sale. The IRS ruled that in the first scenario the payment by the charity to the home buyer was a gift, whereas in the second scenario the payment functioned as a rebate or purchase price adjustment.

Rev. Rul. 76-96

Automobile manufacturer paid cash rebates directly to qualified consumers purchasing its vehicles from dealers. The IRS ruled that the cash payments represented purchase price adjustments rather than taxable income received by the consumer.
State enacted an economic stimulus program that offered cash grants to qualified purchasers. Although unstated, the program appears to have been intended to stimulate the purchases of homes in a particular area. The state entity administering the program issued cash grants to qualified purchasers upon receiving the required documentation of a qualifying purchase. The state entity requested a ruling that the cash grants would not be taxable to the recipients. The National Office disagreed, ruling instead that the amounts were neither purchase price adjustments nor excludable from income under the general welfare exclusion. The National Office concluded that the state entity was not a “party” to the sales transaction, and the grants “do not affect the amount received by any seller, lender, broker, or other party” to the transaction. Instead, “each party to a sale receives the full amount that is due to them; no party receives less to induce the sale” of the property. As such, the cash grants were includible in the purchaser’s income rather than treated as a purchase price adjustment.