



TAX ALERT

October 13, 2011

IRS Issues Pronouncement on Tax Treatment of Section 1603 Grant “Excessive Payments”

Background

On September 27, 2011, the Internal Revenue Service released a pronouncement known as a Chief Counsel Advice (CCA). In this memo, the IRS takes a position on how it intends to deal with the issue of federal income tax treatment of the receipt of “excessive payments” of Section 1603 grants. The IRS position applies to all renewable energy technologies alike, i.e., solar, wind, biomass, as long as they are eligible for the ARRA section 1603 Treasury grant.

Strictly speaking, the CCA deals with just one situation, where, after actually receiving 1603 grant funds, it is later determined by the IRS that a taxpayer received more cash from the Treasury than the rules allow. In that situation, the IRS says that it would treat the taxpayer as claiming more eligible basis than they should have, and taxing them on the excess grant amount as a profit.

Conclusions in the CCA

The IRS reached four main conclusions in the CCA and also foreclosed a few legal defenses to its position.

1. In the event the IRS determines that a taxpayer’s project did not qualify for all or part of a Section 1603 payment it received, the excessive amount of the payment is includible in the taxpayer’s gross income, notwithstanding other provisions of the federal tax code that say such payments are ordinarily not included in income.
2. A taxpayer that receives a Section 1603 payment must include any excessive amount of the 1603 grant payment in its gross income in the taxable year that the taxpayer receives the payment. The taxpayer may, however, deduct repayment of the excessive 1603 grant amount in the taxable year of the repayment to the Treasury. However, if a taxpayer receives an excessive grant amount in the same taxable year that the taxpayer repays the excessive amount, the taxpayer does not include the excessive amount in gross income and does not deduct the repayment. The payments, in essence, net out to zero.
3. There are no other legal provisions that apply to exclude from gross income the excessive amount of a Section 1603 payment.
4. The tax basis in a project for which the taxpayer receives an excessive amount is not reduced by the excessive amount in either the taxable year of receipt or the taxable year of the repayment.



The CCA also makes clear that these excessive payment rules apply where the Section 1603 grant passes through from a lessor to a lessee, as excessive payments can result from using an amount in excess of fair market value of the property to determine the Section 1603 grant.

The IRS also dug deep into legal areas that usually only CPAs and tax attorneys delve into and concluded that excessive 1603 grant amounts cannot be excluded under the general welfare exclusion, because a Section 1603 payment is not intended to help individuals cope with their individual or family needs (e.g., housing, education and basic sustenance expenses). Further, the IRS stated that excess 1603 grant amount cannot be excluded under gift provisions because neither the American Recovery and Reinvestment Act of 2009 nor its legislative history indicated that Congress intended to make 1603 payments proceeds of charity or by virtue of any “detached and disinterested generosity.”

Finally, the IRS concluded that excess 1603 amounts cannot be excluded as a contribution to capital because the 1603 payments are not “non-shareholder contributions to capital” and, furthermore, the IRS said the rules do not provide for an exclusion where the government has no intent to make a contribution to capital.

However, according to the CCA, just because a cost or purported value is not ultimately included in Section 1603 “basis” does not mean that it is not depreciable or amortizable for general federal income tax purposes. Rather, the CCA specifically articulates that if you have an eligible item and do include it in federal taxable income, you thereby get credit to basis for general tax purposes.

What’s New

Specific IRS Action

An IRS Chief Counsel Advice (CCA) is a written instruction prepared by any national office component of the IRS Office of Chief Counsel (OCC) and issued to IRS field employees, including the IRS OCC. In general, a CCA conveys a legal interpretation of a revenue provision or any IRS or OCC policy concerning a revenue provision, including a legal interpretation of law relating to the assessment or collection of any tax liability under a revenue provision.

As our friends at the law firm of Hunton and Williams point out, the memorandum was issued to the Area Counsel for the Office of Natural Resources & Construction of the IRS’s Large Business & International Division. This is the group within the IRS that has principal audit responsibility for renewable energy tax credits. What follows is an overview of the recent IRS comments along with some traps and pitfalls to be aware of.

What the CCA Does

In this CCA, the IRS staked out its position on how it intends to deal with the issue of federal income tax treatment of the receipt of “excessive payments” of Section 1603 grants.

Strictly speaking, the CCA deals with just one situation, where, after actually receiving 1603 grant funds, it is later determined by the IRS that you received more cash from the Treasury than the rules allow. In essence, the IRS would be looking at whether you claimed more eligible basis than you should have, thus making your grant award too big, and because you would thus have “profited” by such excess amount, you should therefore pay federal income tax on that profit.



According to attorneys at the Orrick Herrington & Sutcliffe law firm, “generally a three-year statute of limitations period applies to IRS adjustments to a return but, as the Section 1603 grant affects the tax basis of the grant-eligible project, the IRS could potentially reexamine the grant three years (or more) after the project’s final year of depreciation. The limitations period applicable to any resulting claim by Treasury’s Inspector General for repayment of the Section 1603 grant is uncertain, but likely to extend at least six years from receipt of the grant.”

The IRS “Logic”

It is important to understand the IRS analysis by noting the first principle, or main axiom, of federal income taxation, namely, that the Internal Revenue Code Section 61(a) provides that “gross income means all income from whatever source derived ...”

Given the general legal rule of Section 61, in general, we should not be surprised by the IRS taking the position it holds in this CCA. According to this logic, if you’ve been given cash in excess of the amount that strictly qualifies for the grant, that cash could be viewed as non-grant proceeds, and as such, general cash proceeds subject to general tax under Section 61 of the code.

However, from the perspective of attorney Philip Spector, of the law firm of Troutman Sanders:

“[T]he IRS has taken the position that in the course of an audit of a taxpayer’s return, it has the authority to challenge the amount of a Section 1603 Treasury cash grant previously paid to the taxpayer in the year under audit. This comes as a surprise to many taxpayers who believed that once paid by Treasury, the IRS did not have audit jurisdiction over a cash grant payment.... what will surprise most taxpayers is not the IRS’ calculations, but the fact that the IRS has the authority on audit to challenge the amount of the taxpayer’s Section 1603 payment *at all*. By characterizing the portion of a grant payment that exceeds the allowable amount as an unreported item of gross income, the IRS essentially is asserting audit jurisdiction over every Section 1603 payment that Treasury has ever made. For taxpayers that have applied for and received a grant payment, the Treasury cannot recapture and require repayment of the grant money absent a disqualifying event. However, the IRS has another opportunity to review and challenge the taxpayer’s claim upon audit of the taxpayer’s return for the year the grant was paid. A significant portion of the economic benefit of the grant can be lost if the IRS determines on audit that all or a portion of the grant claimed exceeds the proper amount.”

Therefore, according to Phil Spector:

“...clearly, Treasury is concerned about potential taxpayer abuse in the Section 1603 program. This concern is reflected in the recently issued Treasury guidance describing how Treasury evaluates the tax basis for photovoltaic (PV) solar energy projects. Treasury identified the opportunity to artificially step up basis through excessive developer premiums, transfers between related parties, sale-leasebacks, and in lessee “pass-through” lease transactions (also called “inverted leases”) where basis is deemed to be “fair market value.” Thus, if a lessor passes the Section 1603 payment through to a lessee and that payment to the lessee is based on an amount in excess of the true fair market value of the property, the lessee has received a partially excessive Section 1603 payment. These are the kinds of transactions which may be susceptible to greater IRS scrutiny on audit, with the potential for an unanticipated income inclusion and a reversal of a part of the overall economic benefit of the transaction.”

Expressing a similar concern, Hunton and Williams points out that the CCA raises an issue of particular importance to renewable energy projects in suggesting that the IRS, and not just Treasury, may audit or examine the amount of, or entitlement to, a Section 1603 payment. According to Hunton and Williams, if the CCA memorandum is an indication that



the IRS intends to audit projects that qualify for Section 1603 payments, “it represents a departure from earlier informal announcements that the Service would not audit such projects for purposes of the section 1603 grant.”

In addition, according to attorneys at the law firm of Smith, Gambrell and Russell, “even more disconcerting is the fact that a court could conclude that an audit by IRS is a discretionary, federal action, which decision could bring several other federal laws into play - including the National Environmental Policy Act - which could have significant monetary and other impacts for the taxpayer applicant.”

Granted, none of this detail is spelled out in either the tax code or the 1603 statutes or guidance, but logically the IRS is essentially asserting its general jurisdiction under Section 61 of the Internal Revenue Code to support its position and anticipated actions set forth in the CCA.

The CCA Itself – What It Actually Says

The IRS reached four main conclusions in the CCA and also foreclosed a few legal defenses to its position.

According to the CCA:

1. In the event the IRS determines that a taxpayer’s project did not qualify for all or part of a Section 1603 payment it received, the excessive amount of the payment is includible in the taxpayer’s gross income, notwithstanding other provisions of the federal tax code that say such payments are ordinarily not included in income.
2. A taxpayer that receives a Section 1603 payment must include any excessive amount of the 1603 grant payment in its gross income in the taxable year that the taxpayer receives the payment. The taxpayer may, however, deduct the repayment of the excessive 1603 grant amount in the taxable year of the repayment to the Treasury. However, if a taxpayer receives an excessive grant amount in the same taxable year that the taxpayer repays the excessive amount, the taxpayer does not include the excessive amount in gross income and does not deduct the repayment. The payments, in essence, net out to zero.
3. There are no other legal provisions that apply to exclude from gross income the excessive amount of a Section 1603 payment. The tax basis in a project for which the taxpayer receives an excessive amount is not reduced by the excessive amount in either the taxable year of receipt or the taxable year of the repayment.
4. The CCA also makes clear that these excessive payment rules apply where the Section 1603 grant passes through from a lessor to a lessee, as excessive payments can result from using an amount in excess of fair market value of the property to determine the Section 1603 grant.

Now let’s consider some other less esoteric issues that may cause you some heartburn.

Don’t forget that despite what the IRS may require of you, the Treasury grant program has its own rules and a separate enforcement regime. So the IRS rules laid out in the CCA are only IRS rules, not grant program rules. As such, you do not want to end up in a situation where you have to pay back the Treasury grant program, in the form of cash, 100 percent



of any excess 1603 amount *and* separately pay the IRS tax on that separately taxable amount. So you must be aware of problems that *timing* can cause you when both Treasury grant recapture rules and IRS tax accounting rules mix.

For example: Let's assume that in good faith you end up with an excess 1603 grant amount. Regardless of how it happened, let's say you are a calendar (rather than a fiscal) year taxpayer and you find out on December 31, 2011, that you have an excess payment in your hands. But you learn this after the Treasury has gone home for the New Year's holiday break for 2011. This means that you can't send back the grant money in 2011, and anything you do to fix the problem will be in 2012.

According to the IRS CCA, you must include the excess amount in your 2011 taxable income, so even if you give the money back to Treasury on January 2, 2012, you still end up with taxable income in 2011 and a separate, deferred tax deduction in 2012.

Unless you just happen to have net operating loss (NOL) carry-forwards from previous years, sufficient current deductions or federal tax credits (either current or carried forward) to offset this additional grant income, you will have to pay federal tax, i.e., lay out cash to pay your tax in 2011, and then return the cash to the Treasury grant program in order to get a mere tax deduction on your next year's tax return. However, if in that next year (2012) you are in a loss situation for tax purposes, or you have NOLs carrying forward that may already have zeroed-out your 2012 tax, the deduction allowed by this CCA actually does you no good in 2012.

Furthermore, most states begin their state income tax calculation starting with federal taxable income, so any increase caused by applying the rules in this CCA may also increase your state tax burden as well, and any delays in deductions, as described above, would generally also be delayed at the state tax level as well.

You should be aware that the scenarios above could also be triggered by your own actions, even if you initially got your Treasury grant eligible basis calculation correct. For example, we've recently seen developers who mistakenly overpaid state sales tax on eligible energy equipment that turned out to be exempt from state sales or use tax. So they claimed a state sales tax refund.

Under the rules in the CCA, the instant they received a refund of state sales tax (which was previously and properly included in eligible 1603 grant basis) they self-triggered a reduction in eligible 1603 basis, thus necessitating a recapture of a portion of the grant amount, thereby creating an "excess grant" situation. Presumably, the rules in the CCA would apply even in the case of such state and local tax refunds, as well as to other cases where you may be attempting to be a smart business manager simply seeking reductions or refunds of amounts you otherwise paid. Under the terms of this CCA, doing that after you take possession of your 1603 grant proceeds may give rise to two separate Treasury liabilities: IRS and Treasury proper, as it appears that satisfying the IRS and paying a tax is not the same as allowing Treasury to recapture its grant. This is because, assuming your combined federal and state tax rate was 45 percent, paying tax would only get the Treasury back 45 percent of its cash. Yet the 1603 program general requires recapture of 100 percent of any ineligible amount, keeping in mind that the 5-year 20 percent per year recapture regime applies only to otherwise eligible amounts.

Fortunately, according to the CCA, just because a cost or purported value is not ultimately included in Section 1603 "basis" does not mean that it is not depreciable or amortizable for general federal income tax purposes. Rather, the CCA specifically articulates that, if you have an eligible item and do include it in federal taxable income, you thereby get credit to basis for general tax purposes. Again, the basis reduction rules implicit in this CCA literally and expressly apply for 1603 grant purposes, and expressly apply to tax basis "paid for" by grant money. Therefore, if you're not using grant monies for

your acquisition, you won't have a 1603 Treasury Grant Program-imposed basis reduction. However, to the extent that you are qualified to claim a federal Investment Tax Credit (ITC) on property you didn't also claim the grant on, then a basis reduction could still generally apply, but under the specific federal income tax rules applicable to ITCs.

This is because the procedures and "underwriting" for the 1603 grant program are in practice distinct from the rules the IRS applies to ITC claims, even though technically speaking they're not supposed to differ. Therefore, one might see situations where basis for tax credit purposes is larger than that allowed for Treasury grant purposes.

Again, all this should be considered in consultation with your tax counselor or advisor. Please contact your Reznick Group tax advisor with any questions.

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