Taxation of Government Payments

by Brad Gould, Michael Minton and Dana Apfelbaum
Dean, Mead, Minton & Zwemer, Fort Pierce, Florida

General

As a general rule, payments received are included in gross income, whether received in cash or in kind.[1] Accordingly, government subsidies are included in gross income unless excluded by statute. In the context of government payments for conservation purposes, the primary exclusionary statutes are IRC § 118 and IRC §126. If those exclusions do not apply, the tax liability from government payments can be deferred under IRC §§ 1031 and 1033 if the transaction qualifies. If not, then the tax consequences of the payment will depend upon the nature of the transaction.

Exclusions

A. IRC §118

Contributions to the Capital of the Taxpayer. IRC § 118(a) exempts "contribution to the capital of the taxpayer" from the gross income of corporations. This law, which only applies to corporations, was first enacted in 1954 to codify existing case law holding that certain contributions to the capital of corporations were not taxable income

> where a contribution is made to a corporation by a governmental unit, chamber of commerce, or other association of individuals having no proprietary interest in the corporation. In many such cases because the contributor expects to derive indirect benefits, the contribution cannot be called a gift; yet the anticipated future benefits may also be so intangible as to not warrant treating the contribution as a payment for future services.[2]

Although not discussed in IRC § 118, the Treasury Regulations distinguish between (1) contributions "by a governmental unit or by a civic group for the purpose of inducing the corporation to locate its business in a particular community or for the purpose of enabling the corporation to expand its operating facilities," which IRC § 118(a) excludes from income, and (2) "consideration for goods or services rendered, or to subsidies paid for the purpose to induce a corporation to limit production," which IRC § 118(a) does not exclude from income[3]. The distinction in the regulations concerning the intent behind the payments stem from the two primary U.S. Supreme Court cases on this issue. In Rev. Rul. 93-16, the Treasury Department summarized these two cases as follows:

> In *Detroit Edison Co. v. Commissioner*, 319 U.S. 98 (1943), 1943 C.B. 1019, the Supreme Court held that payments by prospective customers to an electric power company that were used by the company to construct the facilities necessary to deliver electricity to the customers were not nonshareholder contributions to capital. The Court found that the motivation for the prospective customers' contributions was to obtain electric services from the power company and, therefore, the contributions were payment for services.

[1] IRS §61(a); Rev. Rul. 60-32; Notice 99-3, 1999-1 CB 271; Notice 2006-108, 2006-2 CB 1118; All statutory references to the Internal Revenue Code of 1986 (IRC).
[2] S. Rep. No. 1622, 83d Cong., 2d Sess. 18–19 (1954).
[3] See Treas. Reg. § 1.118-1.

In contrast, *Brown Shoe Co. v. Commissioner*, 339 U.S. 583 (1950), 1950-1 C.B. 38, held that money and property contributions by community groups to induce a shoe company to locate or expand its factory operations in the contributing communities were nonshareholder contributions to capital. The Court reasoned that when the motivation of the contributors is to benefit the community at large and the contributors do not anticipate any direct benefit from their contributions, the contributions are nonshareholder contributions to capital.

In addition to the aforementioned cases, the Treasury Department also summarized another U.S. Supreme Court case in Rev. Rul. 93-16. This case, which was decided after the enactment of IRC § 118, set forth the characteristics of "nonshareholder contribution to capital." In *United States v. Chicago, Burlington & Quincy R.R.v. Commissioner*[4], the Court set forth the following five characteristics of a nonshareholder contribution to capital: (1) the contribution must become a permanent part of working capital; (2) the contribution must not be compensation for specific quantifiable services; (3) the contribution must be bargained for; (4) the contribution must foreseeably benefit the corporation in an amount commensurate with its value; and (5) the contribution must ordinarily be employed to generate additional income[5].

In Rev. Rul. 93-16, the Treasury Department held that an Federal Aviation Administration (FAA) grant under its Airport Improvement Program (AIP) to the owner of a public-use airport was a non-shareholder contribution of capital to the owner under IRC § 118(a). The AIP is administered by the FAA to improve public safety and efficiency at public-use airports and to make project grants under the AIP for airport planning and airport development. Airport development includes construction, hazard removal, acquisition or installation of air navigation aids and safety or security equipment, and land acquisition. AIP grants are also available to prepare and implement noise compatibility programs.

AIP funds are primarily used to improve public airports, that is, airports under the control of a public agency, used for public purposes, and publicly owned. The recipient of an AIP project grant must provide free landing rights to government aircraft under certain defined circumstances. The FAA rarely requests landing rights at a privately owned public-use airport, however, so that any benefit to the government is incidental in the context of the overall public purpose of the grant program.

<u>Contributions in Aid of Construction.</u> IRC § 118(b) sets forth an exception to the general rule of IRC § 118(a) by providing that the term "'contribution to the capital of the taxpayer' does not include any contribution in aid of construction or any other contribution as a customer or potential customer." A "contribution in aid of construction" is defined in the Treasury Regulations as "any amount of money or other property contributed to a regulated public utility that provides water or sewerage disposal services to the extent that the purpose of the contribution is to provide for the expansion, improvement, or replacement of the utility's water or sewerage disposal facilities."[6] However, the IRC §118 (b) exception to the general rule of IRC § 118(a) does not apply to a regulated public utility providing water or sewage disposal services if the requirements of IRC § 118(c) are met.

---

[4] 412 U.S. 401 (1973)
[5] 412 U.S. at 413, 1973-2 C.B. at 432.
[6] Treas. Reg. § 1.118-2(b)(1).

> (c)(1) In general. – For purposes of section 118, the term contribution to the capital of the taxpayer includes any amount of money or other property received from any person (whether or not a shareholder) by a regulated public utility that provides water or sewerage disposal services if—
>
> (i) The amount is a contribution in aid of construction under paragraph (b) of this section;
>
> (ii) In the case of a contribution of property other than water or sewerage disposal facilities, the amount satisfies the expenditure rule under paragraph (c) of this section; and
>
> (iii) The amount (or any property acquired or constructed with the amount) is not included in the taxpayer's rate base for ratemaking purposes.
>
> (2)Definitions
>
> (i) Regulated public utility has the meaning given such term by section 7701(a)(33), except that such term does not include any utility which is not required to provide water or sewerage disposal services to members of the general public in its service area.

The expenditure rule provides that the amount must be paid or incurred before the end of the second taxable year after the taxable year in which the payment was received. In addition, the taxpayer must keep a separate accounting of the funds received and expended.[7]

Bifurcation of Funds. The funds received by a corporation for multiple purposes may be bifurcated for purposes of IRC § 118. In *GM Trading Corp. v. Commissioner*[8], the Fifth Circuit Court of Appeals held that payments received by a corporation could be bifurcated into amounts received in exchange for a "specific, quantifiable service" and amounts received as nontaxable contributions to capital. The appeals court found that this bifurcation was permitted by a different Tax Court (than the one involved in the present case) and two 1970 cases from the Ninth Circuit Court of Appeals[9].

---

[7] Treas. Reg. § 1.118-2(c)(1).
[8] 121 F. 3d 977 (5th Cir. 1997).
[9] *Bear Valley Mut. Water Co. v. Riddell*, 283 F.Supp. 949 (C.D.Cal.1968), aff'd, 427 F.2d 713 (9th Cir.1970) (per curiam) and *San Antonio Water Co. v. Riddell*, 285 F.Supp. 297, 311 (C.D.Cal.1968), aff'd, 427 F.2d 713 (9th Cir.1970) (per curiam).

This bifurcation treatment has been disallowed when courts were faces with "a single-part payment, none of which was for a specific service."[10]

B. IRC § 126

IRC § 126(a) excludes specific enumerated federal and state subsidies from gross income if they (1) are "primarily for the purpose of conserving soil and water resources, protecting or restoring the environment, improving forests, or providing a habitat for wildlife," and (2) do not substantially increase the annual income derived from the property, as determined by the IRS. In addition to the eight programs listed in IRC § 126(a), the statute grants the Secretary of Agriculture the ability to determine if an unlisted payment can qualify for exclusion. For example, Secretary of Agriculture determined that cost-share payments under the State of Florida's Agricultural Best Management Practices Program qualify for exclusion pursuant to IRC § 126.[11]

A taxpayer may not tax a deduction for items acquired financed from excluded payments and related expenses cannot be capitalized into in the basis of the property.[12] Since IRC § 126 is an optional provision, a taxpayer must make affirmative election to have IRC § 126 apply.

If property is acquired with payments excluded under IRC § 126, then when such property is sold or disposed of a taxpayer is required to recapture, pursuant to IRC § 1255, all or a portion the excluded amounts in a manner similar to depreciation recapture under IRC § 1245. As such, gain on the disposition is ordinary income to the extent of the IRC § 126 exclusion. However, if the taxpayer disposes of the property after ten years, then the amount treated as ordinary income is reduced by a formula that phases out the ordinary income treatment by ten percent per year that the taxpayer held the property after receipt of the excluded payment. Thus after twenty years, none of the gain is treated as ordinary income. This recapture rule is a trap for the unwary that could put the taxpayer in a less favorable position than would have been obtained in the absence of IRC § 126.

<u>Requirement of Capital Improvement.</u> Although IRC § 126 operates to prevent a double benefit, in order to qualify for the exclusion thereunder, the payment at issue must be for a capital improvement. [13] In *Graves v. Commissioner*,[14] the Tax Court held that payments to farmers who set aside land as a wildlife habitat were not excludible under IRC § 126 as such payments were not received to assist with the cost of a depreciable capital improvement. In that case, a mere reduction in the farmers' income due to their participation in the program was not considered a "cost-sharing payment" within the meaning of IRC § 126.[15] Payments for land-based structural practices, however, should qualify so long as the practice is a capital improvement.

<u>Determination of Amount Includable in Gross Income.</u> The amount of gross income realized by a taxpayer upon the receipt of a payment that qualifies for IRC § 126 is equal to the

---

[10] *GM Trading Corp.* at 982, citing to *Putoma Corp. v. Commissioner*, 601 F.2d 734 (5th Cir. 1979) and *Federated Dep't Stores, Inc. v. Commissioner*, 51 T.C. 500 (1968), aff'd 426 F.2d 417 (6th Cir. 1970).
[11] Notice of Determination74 FR 49850-01
[12] IRC §§ 126(d), 126(e).
[13] Temp. Reg. § 16A.126-1(a).
[14] 89 T.C. 49 (1987).
[15] Id.

value of the improvement[16] less the sum of the excludable portion under IRC § 126 and the taxpayer's share of the cost of the improvement.[17] In the terms of IRC § 126, "payment" means payment of an economic benefit to the taxpayer upon receipt of an improvement.[18]

Assuming that the Secretary of Agriculture certifies that 100 percent of the payments from a program are primarily for the conservation purposes described above and no portion of the payment is for rent or compensation,[19] the amount included in gross income hinges on the determination of the "excludable portion" of a payment. With regard to the increase in annual income, Treas. Reg. § 16A.126-1 provides a calculation to determine the "excludible portion" of a payment. An increase in annual income, measured on gross receipts, is considered to be substantial if it exceeds the greater of 10 percent of the average gross income derived from the affected property prior to the receipt of the improvement **<u>or</u>** an amount equal to $2.50 times the number of affected acres.[20]

Accordingly, the "excludable portion" is defined to mean "the present fair market value of the right to receive annual income from the affected acreage of the greater of 10 percent of the prior average annual income from the affected acreage or $2.50 times the number of affected acres."[21] In this context, prior average annual income means the average gross receipts from the affected acreage for the last three taxable years preceding the taxable year in which installation of the improvement began.[22]

Four examples regarding the application of these rules and illustrations of the calculations involved can be found in Treas. Reg. § 16A.126-1.

<u>Treatment on Later Sale or Disposition.</u> On a sale or other disposition of property acquired, improved, or otherwise modified by expenditures financed with the excluded IRC § 126 payments, IRC § 1255 requires a recapture of these amounts on a sliding scale, subject to rules similar to those applicable to the recapture of depreciation under IRC § 1245. Specifically, gain on the disposition is ordinary income up to the amount of the IRC § 126 exclusion, reduced by 10 percent for every year in excess of ten years that the taxpayer held the property following receipt of the excluded amount. This recapture rule is a trap for the unwary that could put the taxpayer in a less favorable position than would have been obtained in the absence of IRC § 126. Thus, the decision to elect to utilize IRC § 126 requires careful planning.

Deferral Opportunities

In the event that government payments are not excluded from income, the activities of the recipient or the government in connection with the payments could result in the deferral of any tax associated with the payment. These opportunities arise from IRC §§ 1031 and 1033, but the availability of these deferral opportunities require that the government payments qualify.

A. Like-Kind Exchanges

---

[16] Temp. Reg. § 16A.126-1(b)(3).
[17] Temp. Reg. § 16A.126-1(a).
[18] Temp. Reg. § 16A.126-1(a).
[19] Any amount paid as rent or compensation is ineligible for IRC § 126 exclusion. Temp. Reg. § 16A.126-1(b)(2)(iii).
[20] Temp. Reg. § 16A.126-1(a).
[21] Temp. Reg. § 16A.126-1(b)(5).
[22] Temp. Reg. § 16A.126-1(b)(6).

If the transaction rises to the level of a sale of assets by the taxpayer to the government, then IRC § 1031 affords the opportunity for the taxpayer to reinvest the proceeds into like-kind property. Under IRC § 1031(a), a taxpayer recognizes no gain or loss on the exchange of property (relinquished property) held for productive use in a trade or business or for investment, for other property (replacement property) of a like-kind that is to be held for productive use in a trade or business or for investment. This provision is an exception to IRC § 1001(c), which provides that gain or loss realized on the exchange of property is recognized when the exchange occurs. The gain or loss that would otherwise be recognized on the exchange is only deferred. Preservation of the unrecognized gain or loss is accomplished by giving the property received in a like-kind exchange (the replacement property) a substitute or exchanged basis equal to the taxpayer's adjusted basis in the property transferred in the exchange (the relinquished property).

In order to qualify for deferral under IRC § 1031, specific rules over the timing of the exchange (the replacement property must be acquired within 180 days) and control of the sales proceeds must be strictly followed. In addition, the determination of whether property is like-kind is determined on a case by case basis, however, real property is always considered like kind to other real property even though the nature of the property is different. For example, an office building is considered like kind to improved pastureland.

In addition to the foregoing, a leasehold interest for at least 30 years is considered like kind to a fee simple interest in real estate.[23] For example, the sale of a 30-year lease in improved pastureland is considered like kind to buying a fee simple interest in other improved pastureland. Furthermore, in some cases it may be possible for a 30-year conservation easement to receive similar treatment as a 30-year lease.[24]

B. Involuntary Conversions

Gain is not recognized when property is involuntarily or compulsorily converted into property that is similar or related in service or use to the property so converted. If the taxpayer receives money or other non-similar property (e.g., insurance proceeds or a condemnation award), gain is recognized unless the taxpayer (1) buys property that is similar or related in service or use to the original property (replacement property) within a prescribed time period and (2) elects under IRC § 1033 to limit the gain recognition.

The core of IRC § 1033 is the deferral of gain when property is involuntarily converted "as a result of requisition or condemnation or threat or imminence thereof," terms that account for most of the litigation and administrative rulings under IRC § 1033. However, an actual taking does not need to occur. IRC § 1033 treatment is available if a property owner is informed, either orally or in writing by a representative of a governmental body or public official authorized to acquire property for public use, that such body or official has decided to acquire the property, and from the information conveyed to the owner, the owner has reasonable grounds to believe that the property will be condemned if a voluntary sale is not arranged.

However, condemnation or seizure doesn't include the temporary use of a taxpayer's property by the government if title and other incidents of ownership remain with the taxpayer. In that case, compensation or rental payments to the taxpayer are ordinary income, not payments in

---

[23] Treas. Reg. §1.1031(a)-1(c)
[24] Rev. Rul. 72-601, 1972-2 C.B. 467, holding that Treas. Reg. §1.1031(a)-1(c) also applies to other temporary interests in property.

exchange for the property within a certain amount of time. The amount of time to acquire the replacement property is significantly greater, up to three years in certain cases for property used in a trade or business, and the taxpayer has full control of the sales proceeds until the reinvestment is made.

In order to analyze if government payments qualify for IRC § 1033 treatment, a taxpayer would need to establish and document: (1) the nature of the subject property and how it was used by the taxpayer; (2) if the government agency threatened to exercise its eminent domain authority in connection with the acquisition of the taxpayer's property; and (3) what rights, if any, the taxpayer retained in the property.

Long-Term Capital Gain vs. Ordinary Income

Gross income includes gains derived from dealings in property. Generally, a sale, exchange, or other disposition of property gives rise to a gain or a loss. Gain is the excess of the amount realized over the adjusted basis; loss is the excess of the adjusted basis over the amount realized. A seller generally recognizes the full amount of gain or loss realized on the sale or exchange of property, unless an exception applies (such as under IRC §§ 1031 and 1033 discussed above). Gains and losses can be ordinary or capital, depending on whether the property sold or exchanged is a capital asset.

Classification of an item as a capital asset may enable a noncorporate seller to use special tax rates on a sale or exchange. Ordinary income is taxed, for pass-through entities and noncorporate taxpayers (partnerships, S corporations individuals, estates, and trusts), at a rate than can be as high as 39.6%. However, preferential rates apply to long term the net capital gains. These preferential rates range from 0% to 23.8%. C corporations do not get a preferential rate for capital gains and are taxed at a rate as high as 38.6% (combined federal and state rates).

A. Conservation Easements

Conservation easements are perpetual, undivided interests in property and may be created in the form of a restriction, easement, covenant, or condition in any deed, will, or other appropriate document. Such an easement can be created by the sale of the easement to another party. Typically, this is done with a governmental agency that needs the land for various preservation purposes. For example, SRWMD purchases flowage easements from landowners for the restoration of a river within its boundaries.

The sale of a conservation easement can be treated for tax purposes as if the entire property was sold. The threshold tax issue is to determine if the property rights sold are significant enough to treat the transaction as a sale of real property. If not, then the transaction is treated as a return of the taxpayer's capital. In that case, the transaction is treated as the sale of an interest in real property.[25]

B. Impairment of Capital

If a taxpayer were to receive funds under a government program but the underlying transaction does not rise to the level of a sale of the property, then the taxpayer may have suffered an impairment of capital. Under such a scenario, which can arise when sales of conservation easements do not rise to the level of a sale for tax purposes or if the taxpayer would be required to permanently change the purposes for which the property could be used, the

[25] See Rev. Rul. 59-121, 1959-1 C.B. 212

proceeds received are first treated as a recovery of the taxpayers basis in the property. Any excess is treated as gain or ordinary income, depending on nature of the subject property.