

Office of Chief Counsel
Internal Revenue Service
Memorandum

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date: July 29, 2005

to: Territory Manager, Compliance,

from: Associate Area Counsel (SB/SE)

subject: **Advisory Opinion: Taxability of Payments to Recipients Under the Fund**

This document may not be used or cited as precedent. This memorandum relates to a request to our office from the Service for advice relating to the federal income tax ramifications of a new law signed by the Governor on , 2005, establishing the

Fund for the purpose of providing payments to taxpayers who filed a state income tax return for the preceding tax year. Specifically, it was asked: (1) whether payments to taxpayers under the new law will be taxable to the recipients; and (2) whether the State will be required to issue a Form 1099-G to each recipient.

CONCLUSIONS

If the payments constitute a gift to a class of recipients rather than refunds of taxes previously paid, then the payments are excluded from gross income under I.R.C. § 102. Based on the available information, it does not appear that the payments constitute excludable gifts, as they appear prompted by the

State's moral obligation to its taxpayers and/or by an anticipated benefit, rather than out of disinterested generosity.

If the payments constitute a refund of taxes previously paid, then the payments must be analyzed under the tax benefit rule, as partially codified by I.R.C. § 111. Under the rule, a refund is included in a recipient's gross income under I.R.C. § 61 if it is a refund of tax deducted in a prior year, to the extent the amount of the deduction reduced the recipient's tax, i.e., to the extent the deduction resulted in a tax benefit.

Based upon the available information, the payments appear to be made to a designated class of recipients without regard to whether the recipients made prior payments of tax, rather than payments made to persons who are entitled to "refunds" of taxes previously paid. The payments do not correspond to tax paid by taxpayers but to the State's surplus; the payments do not relate to tax paid on account. In such case, the payments will generally be deemed gross income under I.R.C. § 61, absent an exclusion.

If the payments do not constitute a refund of State income taxes, the State will not be required to report the payments to the Service under I.R.C. § 6050E(a) or issue a Form 1099-G to recipients who claimed itemized federal income tax deductions in the preceding year under I.R.C. § 6050E(b). If the payments do not exceed \$600, the State would not be required to report the payments under I.R.C. § 6041(a).

FACTS

On , 2005, the Governor signed
an "[a]ct relating to public finance," which adds new
sections of law

. Section 1 of the act
reads as follows:

:

Section 2 of the act
reads as follows:

Finally, section 3 of the act
reads as follows:

The Constitution provides that, to ensure a balanced annual budget, the State must certify the total amount of revenue which accrued during the preceding fiscal year (ending) to the General Revenue Fund and to each Special Revenue Fund appropriated directly by the legislature, and must also certify amounts available for appropriation for the next ensuing fiscal year, showing separately the revenues to accrue to the credit of each fund.

. The certification is filed with the Governor and the legislature, and the legislature cannot pass or enact any bill making an appropriation of money for any purpose until such certification is made and filed.

The Constitution also provides that surplus funds or monies shall be any amount accruing to the General Revenue Fund over and above the itemized estimate made by the State

. All such surplus funds or monies must be placed in a Fund (commonly referred to as "Fund") by the State Treasurer until such time that the amount of the Fund equals (%) of the General Revenue Fund

certification for the preceding fiscal year.

Our office was provided with documents entitled
Apportionment of Statutory Revenues

for the fiscal years ending
, 2004 and , 2005. The documents reflect the amount of
revenues in the General Revenue Fund and several special funds
(the

Fund is not listed, perhaps because the report for the fiscal
year ending , 2005 is dated , 2004). The documents reflect
that the General Revenue Fund is composed of a variety of
sources, including excise taxes, licenses, individual and
corporate income tax, motor vehicle tax, sales tax, workers
compensation insurance tax, etc.

The apportionment document for the fiscal year ending
, 2004, which
is stated in dollars, reflects that of the total apportionment of
\$, \$ (approximately %) is apportioned to the
General Revenue Fund, and the remainder is apportioned to special
funds. Income taxes revenues have a total apportionment of \$
, \$ of which is apportioned to the General
Revenue Fund. The \$ income tax apportionment constitutes
approximately % of the total apportionment to the General
Revenue Fund. The Apportionment document for the fiscal year
ending , 2005, which is stated in percentages, reflects that
% of corporate income taxes and % of individual income
taxes are apportioned to the General Revenue Fund. The ratio of
income tax apportionment to the total General Revenue
apportionment, however, cannot be determined.

While legislative history on the bill is apparently non-
existent, we note that the contains a message of Governor
message on the Legislative Day, , 2005. In the
message, Governor states:

Message of Governor .

Recently, it was reported that the chairman of the House Appropriations and Budget Committee and co-sponsor of the bill, , stated that surplus projections of \$ million for the fiscal year appeared overstated, that

house analysts now project a \$ million surplus, that State payments may be \$ per taxpayer rather than \$, and that final figures for the fiscal year will not be known until legislators re-convene in .

. According to the report, the State Treasurer stated that it may be August before officials know the amount of the surplus, but that the Fund" will be "maxed out" for the first time, thus enabling the payments. Id.

DISCUSSION

Taxability of Payments

Section 61 of the Internal Revenue Code provides that, except as otherwise provided, gross income means all income from whatever source derived. The Supreme Court has long recognized that the definition of gross income is broad, and reflects Congress' intent to exert the full measure of its taxing power to bring within the definition of income "any accession to wealth." Commissioner v. Schleier, 515 U.S. 323, 327 (1995); United States v. Burke, 504 U.S. 229, 233 (1992). Thus, the payments from the State will be taxable to recipients under I.R.C. § 61 unless the payments meet an exclusion provided by the Code, e.g., a non-taxable gift under I.R.C. § 102 or a non-taxable refund under I.R.C. § 111.

Gift Characterization

Under I.R.C. § 102(a), gross income does not include the value of property acquired by gift. Neither the Code nor legislative history defines the term "gift." The Supreme Court, however, has explained that a gift proceeds from a "detached and disinterested generosity," and is made "out of affection, respect, admiration, charity or like impulses." Duberstein v. Commissioner, 363 U.S. 278, 285 (1960). If a payment proceeds primarily from "any moral or legal duty," or from "the incentive of anticipated benefit" of an economic nature, it is not a gift. Id.

In general, payments made by a state government do not qualify as non-taxable gifts because it is not the purpose of governments to make gifts to its citizens. However, in certain situations, a government payment may be treated as a non-taxable

gift under I.R.C. § 102. In the few cases that treat payments by governments as non-taxable gifts, the payments generally have been made to a class of individuals and the payments have been based on the activities of that class, such as veterans who served in the armed forces during a certain war, or individuals who worked on the construction of the Panama Canal. See Rev. Rul. 76-131, 1976-1 C.B. 16, and Rev. Rul. 85-39, 1985-1 C.B. 21. See e.g., Rev. Rul. 55-609, 1955-2 C.B. 34 (death gratuity payments specifically designated by Congress as gifts were gifts); Rev. Rul. 68-158, 1968-1 C.B. 47 (state payments to or on behalf of veterans who served in the Armed Forces during war time were not includible in gross income); and Dewling v. United States, 101 F. Supp. 892 (Ct. Cl. 1952) (payments from the federal government were gifts in recognition of the services rendered for construction of the Panama Canal built thirty years prior to payment).

In many cases, the government payments fail as gifts because they are prompted by a moral or legal duty and/or in anticipation of a future benefit. For instance, in Kroon v. United States, 74-2 U.S.T.C. ¶ 9,641 (D. Alaska), homeowners received payments from the State of Alaska pursuant to the Alaska Mortgage Adjustment Program to retire the mortgages on residences destroyed by an earthquake. The court held that the payments were not gifts under I.R.C. § 102 and were thus includible in the homeowner's gross income because the payments were prompted out of the state's moral obligation to its citizens rather than out of charity and disinterested generosity. Id. The court stated:

The government and a private donor differ in nature.

Whereas in some instances a payment from the government and a private donor could both be classed as gifts, in this instance, the government owes a type of duty not incumbent upon a private donor to relieve hardship caused by a natural disaster. Alternatively, it may be contended that the government benefits more than a private donor in these situations in that a stronger economy increases the tax base.

Id. See also Foley v. Commissioner, 87 T.C. 605, 609 (1986) (payments from the West Berlin government to its residents and workers designed to encourage consumption and spending to improve West Berlin's economic vitality were not gifts under I.R.C. § 102); Beattie v. United States, 635 F. Supp. 481 (D. Alaska

1986), affd., 831 F.2d 916 (9th Cir. 1987), cert. denied, 485 U.S. 1006 (1988) (Alaska state fund, consisting of oil royalties, was created to effect an equitable distribution of a portion of state wealth resulting from the royalties, encourage residential longevity in the state, and encourage involvement by residents in the management and expenditure of the fund, and thus, fund dividend payments were not gifts).

In this case, whether the payments by the State of _____ to taxpayers are gifts depends upon all the facts and circumstances. The new act creating the _____ Fund, by its own terms, is one "relating to public finance." Also, the Governor's message indicates that the act is referred to as the _____ Act and is a "tax-relief and investment package." Further, the purpose of the act's other fund, the _____

_____ Fund, is to promote various State economic and social interests. The legislative intent gleaned from these facts suggests that the payments are prompted by the State's moral obligation to its taxpayers and/or by an anticipated economic benefit to the State rather than out of charitable impulses or disinterested generosity. Lastly, although according to the Governor's message, the excess funds are to be returned to _____

taxpayers "who most deserve it," the payments are based on a taxpayer's filing of a state income tax return for the prior year and the payment amount merely depends on the filing status on the return, not the needs of the recipient.

Based on the available facts, it does not appear that the payments would proceed from a "detached and disinterested generosity," made "out of affection, respect, admiration, charity or like impulses," including charitable impulses motivated by the needs of the recipient, but instead arise from a "moral or legal duty" and/or an "incentive of anticipated benefit" of an economic nature. Furthermore, the payments made by the State of _____

_____ to taxpayers are not limited to a class of recipients based on merit or service. Consequently, the facts and circumstances, including _____

the legislative intent behind the payments, lead us to conclude that the payments are not gifts under I.R.C. § 102.

Refund Characterization

As indicated, the payments from the State appear not to be gifts. The question then arises as to whether the payments are made to a designated class of recipients without regard to whether the recipients made prior payments of tax, or whether the payments are made to persons who are entitled to "refunds" of taxes previously paid. In the case of the former, the payments will generally be deemed gross income under I.R.C. § 61, absent an exclusion. In the case of the latter, the recovery of the refund of taxes previously paid will only be deemed gross income under the "tax benefit rule" to the extent the taxpayer claimed a federal deduction for the payment in the preceding year.

The tax benefit rule is partially codified under I.R.C. § 111(a), which provides that gross income does not include amounts attributable to the recovery during the taxable year of any amount deducted in any prior year to the extent that the amount did not reduce the amount of federal income tax imposed by the Code. The tax benefit rule generally requires the inclusion in income of amounts that were deducted by a taxpayer in a prior taxable year to the extent those amounts generated a tax benefit to the taxpayer through a reduction in the amount of the tax liability in the prior year. See Rev. Rul. 93-75, 1993-2 C.B. 63; Hillsboro National Bank v. Commissioner and United States v. Bliss Dairy, Inc., 460 U.S. 370 (1983).

The purpose of the rule is to achieve a rough transactional parity, i.e., the taxpayer is "put in more or less the same after-tax position as if only the proper amount had been deducted." Id., citing S. Print 98-169, Vol. I, 98th Cong., 2d Sess. 472 (1984). Thus, a refund of State tax paid that was previously deducted is includible in gross income in the year of receipt to the extent of the difference between the taxpayer's deductions in the prior year and the deductions the taxpayer would have claimed had the taxpayer paid the proper amount of State tax in the prior year and not received a State tax refund in a subsequent year. Id.

In other words, the payment will be a taxable refund to the extent that the taxpayer took a deduction in a prior year for that payment. For example, a taxpayer who took a federal income

tax deduction (e.g., Schedule A itemized deduction or Schedule C business deduction) for State income taxes, personal property taxes, sales taxes, etc., in the preceding year would have a taxable refund of those taxes to the extent the taxpayer benefited from the deduction. Likewise, a taxpayer who did not claim a deduction for State or local tax paid would not have a taxable refund.

However, the payments in this case appear to be made to a designated class of recipients without regard to whether the recipients made prior payments of tax, rather than payments made to persons entitled to "refunds" of taxes previously paid. While individuals eligible to receive the payments are those individuals who filed a State income tax return for the preceding year, the payment is not based upon State or local tax that an individual taxpayer reported and paid, but on whether the taxpayer claimed a personal exemption. This eligibility requirement appears to simply be a method for designating a class of individuals to whom the State desires to make a payment of surplus funds.

Also, persons entitled to refunds of monies may file a claim for refund at any time within three years from the due date of the return. . Such claims shall be filed and paid under section , and if allowed, shall be paid under the provisions of that section. Section provides that, if upon review and adjustment, any refund is found to be due any taxpayer, it shall be paid out of the

Account created by
in the same manner as refunds are paid under that section. . The amount of the refund shall not exceed the portion of the tax paid during the three-year period immediately preceding the filing of the claim.
Id.

The payments in this case do not appear to have the character of refunds of tax previously paid. As indicated above, the payment is not based upon tax that a taxpayer actually paid, but relates solely to whether a taxpayer claimed a personal exemption in the preceding year. The payments do not relate to taxes paid by taxpayers on their account, i.e., the payments do not represent refunds of overpayments on the accounts. The payments also do not result from amounts erroneously paid by taxpayers, through error of fact, computation, or

misrepresentation of law. Because the payments do not relate to taxes paid on account, they are not paid out of the

Account, as are normal refunds. Instead, they are paid out of the excess of the

Fund from a multitude of revenue streams that flow into the Fund from the General Revenue Fund.

Further, the new act does not provide that the payments are specifically termed "refunds" of tax. Also, there is no indication that taxpayers would have the same right to payment of the payment as they would a refund, whereby they may claim a refund for taxes paid relating to the payments within three years. The payment, rather, appears to be solely a result of the State's increased revenues for the preceding year in an amount which exceeds the Fund. Based upon these facts, the payments appear to be made to a designated class of recipients without regard to whether the recipients made prior payments of tax, rather than payments made to persons entitled to "refunds" of taxes previously paid, and are includible in gross income under I.R.C. § 61.

Information Reporting Requirement

To the extent the payments constitute a refund of State income tax, I.R.C. § 6050E(a) provides that every person who, with respect to any individual during any calendar year, refunds, credits, or offsets State income tax aggregating \$10 or more shall make a return setting forth the aggregate amount of such payments, credits, or offsets, and the name and address of the individual with respect to whom such payment, credit, or offset is made. Under I.R.C. § 6050E(b), every person required to make a return under subsection (a) is also required to furnish each individual whose name is required to be set forth in the return a written statement showing the name of the State and the information required to be shown on the information return with respect to refunds, credits, and offsets to the individual.

No such written statement shall be required, however, if it is determined that the individual did not claim itemized deductions for the taxable year giving rise to the refund, credit, or offset, i.e., "non-itemizers." I.R.C. § 6050E(b); Treas. Reg. § 1.6050E-1(k)(2). Verification is made from the State income tax return, as an individual who itemizes deductions for federal income tax purposes must either attach a copy of

Schedule A to the State return, or transcribe the Schedule A information to the State return. Id. Under Treas. Reg. § 1.6050E-1(c), every refund officer who makes payments of refunds of State income taxes aggregating \$10 or more for an individual in any calendar year, shall make an information return for that calendar year. Thus, the return is required even if, under the exception for non-itemizers, the refund officer is not required to furnish a statement to the applicable taxpayer. See Rev. Rul. 1986-140, 1986-2 C.B. 195.

Even if the payments do not constitute a refund of State income or other taxes, I.R.C. § 6041(a) provides that all persons engaged in a trade or business and making payment in the course of such trade or business to another person, of rent, salaries, wages, premiums, annuities, compensation, remuneration, emoluments, or other fixed or determinable gains, profits, and income of \$600 or more in any taxable year shall render a true and accurate return to the Service, setting forth the amount of such gains, profits, and income, and the name and address of such payment. The regulations provide that payments made by a state or a political subdivision are subject to this reporting requirement. Treas. Reg. § 1.6041-1(b)(1). If the amount of the payment is less than \$600, then there is no reporting requirement under I.R.C. § 6041.

Conclusion

If the payments constitute a gift to a class of recipients rather than refunds of taxes previously paid, then the payments are excluded from gross income under I.R.C. § 102. Based on the available information, it does not appear that the payments constitute excludable gifts, as they appear prompted by the State's moral obligation to its taxpayers and/or by an anticipated benefit, rather than out of disinterested generosity.

If the payments constitute a refund of taxes previously paid, then the payments must be analyzed under the tax benefit rule, as partially codified by I.R.C. § 111. Under the rule, a refund is included in a recipient's gross income under I.R.C. § 61 if it is a refund of tax deducted in a prior year, to the extent the amount of the deduction reduced the recipient's tax, i.e., to the extent the deduction resulted in a tax benefit.

Based upon the available information, the payments appear to be made to a designated class of recipients without regard to whether the recipients made prior payments of tax, rather than payments made to persons who are entitled to "refunds" of taxes previously paid. The payments do not correspond to tax paid by taxpayers but to the State's surplus, and the payments do not relate to tax paid on account. In such case, the payments will generally be deemed gross income under I.R.C. § 61, absent an exclusion.

If the payments do not constitute a refund of State income taxes, the State will not be required to report the payments to the Service under I.R.C. § 6050E(a) or issue a Form 1099-G to recipients who claimed itemized federal income tax deductions in the preceding year under I.R.C. § 6050E(b). If the payments do not exceed \$600, the State would not be required to report the payments under I.R.C. § 6041(a).

If you have any questions, please call _____, the attorney in our office assigned to this case, at extension _____.

Associate Area Counsel (SB/SE)

cc: _____,

Attn: