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Memorandum

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subject:

Tax Year:

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LEGEND

Taxpayer =
State =
Statute =
$a =
$b =
$c =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
Date 1 =
Date 2 =
Date 3 =

Date 4 =
Date 5 =
Allocation Date =

ISSUES

1) Does Taxpayer realize gross income when premium tax credits (PTCs) are utilized as payments of principal and interest under the State Certified Capital Company ("CAPCO") program?

2) Does the potential recapture or forfeiture of PTCs allow Taxpayer to defer the recognition of income under the all events test?

CONCLUSIONS

1) Taxpayer will realize gross income when PTCs are utilized as payments of principal and interest on notes issued to investors under the State CAPCO program.

2) The all events test is met as the loan repayments are deemed made through the utilization of PTCs offset. The ability to meet all filing and reporting requirements of the State CAPCO program to maintain certification is solely within Taxpayer's control, therefore, any action or inaction that causes the recapture or forfeiture of PTCs would be a condition subsequent.

FACTS

The State Legislature implemented its CAPCO program in Year 1[1]. The State CAPCO program provides alternative sources of venture capital to State entrepreneurs through private government-sponsored venture capital companies. Typically, venture capital groups with significant local knowledge and industry expertise form CAPCOs and invest funds received from insurance companies in qualified small businesses. To attract investments in CAPCOs, State provided PTCs to insurance companies in exchange for their investment in the CAPCOs[2].

Under the State CAPCO program, insurance companies certified their intent to participate in the program by filing a PTC allocation claim form which detailed the amount of the planned investments and the identity of the CAPCOs that would receive the investments[3]. Only insurers who were required to pay a premium tax on insurance

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[1] The enabling legislation which was passed in , approved a total of in PTCs to be used for Program 1. A second program was later approved and implemented in .

[2] Several other states implemented similar programs beginning in the 1990's.

[3] PTCs were allocated based on total investments and the maximum credits allowed for each program. Investors were legally bound to make investments in CAPCOs within a short period of time after the allocation date.

policies issued in the State were eligible to invest in CAPCO-issued debt instruments. Insurers that invested in debt or equity securities of a certified CAPCO (certified investors) earned, in the year of investment, an amount equal to 100% of such investment. The PTCs are vested credits that can be claimed as a dollar-for-dollar reduction of taxes on policy premiums. A unique feature of the State CAPCO program is the deferral of these PTCs. Although the PTCs were allocated in Year 1, they could not be utilized until the filing of Year 2 premium tax returns in March of Year 3, and the PTCs could not be applied to estimated payments due in Year 2. In addition, certified investors could not claim more than 25% of their allocated PTCs in any one year. If a certified investor could not use the total PTCs available in a tax year, it could carry the unused PTCs forward indefinitely.

In order to maintain certification, CAPCOs must meet certain filing, reporting, and investment requirements. All CAPCOs must file a prescribed annual report with the State Comptroller by January 31 of each year providing details about its operations and investments as required by Statute. CAPCOs also have to pay an annual renewal fee of $5,000 and must submit, on a yearly basis, audited financial statements that include the opinion of an independent certified public accountant as to whether the CAPCO is in compliance with the program's rules. Investments must be placed in "qualified businesses," and must be diversified with no more than 15 % of certified capital in any single company.

To remain certified, CAPCOs must meet certain investment milestones: 30 % of certified capital must be placed in qualified businesses within 3 years from the allocation date, and 50 % within 5 years from the allocation date. If these investment milestones are not met, the PTCs may be subject to recapture or forfeiture. Once a CAPCO has satisfied the 5 year 50% investment milestone, any PTCs that have been or will be taken by its certified investors within five years of the allocation date are no longer subject to forfeiture or recapture. Tax credits to be taken after the fifth anniversary of the allocation date are subject to forfeiture only if the CAPCO is decertified within the five year period after the allocation date. If a CAPCO does not meet any of the requirements on a timely basis, it is given 120 days to correct the deficiency and may be subject to a late fee or administrative penalty. As of Year 4, no CAPCO had been decertified from the State's CAPCO program[4].

Taxpayer is a State CAPCO. On the allocation date, $a in PTCs was allocated to Taxpayer's investors. After receiving the PTCs, the investors made required investments through the issuance of notes. On Date 3, Taxpayer and the investors executed the notes in the amount of $a. Under the terms of the notes, principal and interest were to be paid twice a year over a six-year period, commencing on August 1, Year 1. The payments were structured so that the amount of the PTCs available each year would be applied to offset a portion of the principal and interest payments due that year, with the balance paid through the liquidation of securities pledged to secure the notes. Under the terms of the notes, if investors are unable to use PTCs in any year

[4] State Comptroller of Public Accounts biennial report on the results of the CAPCO program for the period ending January 1, 2010.

because they have insufficient State insurance premium tax liability, the tax credit offset against amounts due under the notes for that year will not be postponed. Taxpayer made the first seven payments in cash, but starting with the eighth payment on Date 1, the payments on the notes were deemed to be made solely through the PTCs available to the investors. According to Taxpayer's note-payment schedule, on Date 1 and Date 2, the Taxpayer made payments to investors via tax credits offset in the amounts of $b, and $c, respectively. Taxpayer is expected to make all future payments in the same manner.

LAW AND ANALYSIS

Issue 1

Section 61 generally provides that gross income means all income from whatever source derived. The term "income" is broadly defined as "instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955).

It is well established that the payment of the expenses of a taxpayer by another is includible in the taxpayer's gross income. Old Colony Trust v. Commissioner, 279 U.S. 716 (1929) (payment of employee's income taxes by the employer made in consideration of employee's services constituted additional taxable income of employee). Moreover, the payments are includible in the taxpayer's gross income regardless of whether they are made directly to the taxpayer or to a third party on the taxpayer's behalf. See Old Colony at 729, which held it "immaterial that the taxes were paid over directly to the government. The discharge by a third person of an obligation [of the taxpayer] is equivalent to receipt by the [taxpayer]." Vasquez v. Commissioner, T.C.M. 1997-78 (repayment of student loans by employer includable in student's gross income).

In this case, the State, in effect, is discharging Taxpayer's obligation to pay investors principal and interest by providing the investors with PTCs. Consequently, to the extent that Taxpayer does not make an actual payment of principal and interest due under the terms of the note because the investors have used or will use PTCs earned under the CAPCO program, Taxpayer must include in gross income an amount equal to the PTCs available to investors to be utilized, even if actual utilization is postponed indefinitely.[5]

Issue 2

Section 451 provides the general rule that the amount of any gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless such amount is to be properly accounted for in a different period.

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[5] In Year 3, the payments due under the notes approximated the amount of PTCs available to be taken by the investors for Year 2 and Year 3.

Section 1.451-1(a) of the Income Tax Regulations provides that gains, profits, and income are to be included in gross income for the taxable year in which they are actually or constructively received by the taxpayer, unless includible for a different year in accordance with the taxpayer's method of accounting. Under an accrual method of accounting, income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy (the "all events test"). Section 1.446-1(c)(1)(ii)(A). All the events that fix the right to receive income occur when (1) the required performance takes place, (2) payment is due, or (3) payment is received, whichever happens earliest. See Schlude v. Commissioner, 372 U.S. 128, 133 (1963); Rev. Rul. 84-31, 1984-1 C.B. 127; Rev. Rul. 80-308, 1980-2 C.B. 162.

Taxpayer uses an overall accrual method of accounting. To participate in the CAPCO program, Taxpayer must maintain certified status and is required to meet the 30% investment milestone by the third anniversary of the allocation date, and the 50% investment milestone by the fifth anniversary of the allocation date. The taxpayer met the 30% investment milestone timely. The fifth anniversary of the allocation date fell on Date 5, but the Taxpayer met the 50% investment milestone by Date 4.

Because Taxpayer met its 50% investment milestone by Date 4, the agents question whether the potential for forfeiture or recapture postpones the recognition of income under the all events test until Year 4, the end of the 5-year period.

Statute provides that once a CAPCO has satisfied the 50% investment milestone, PTCs that have been or will be taken by its certified investors during that five-year period are no longer subject to forfeiture or recapture, whereas PTCs to be taken after the fifth anniversary of the allocation date are subject to forfeiture only if the CAPCO is decertified within the five-year period. In this case, the only actions that could trigger decertification before the end of the five-year period, are Taxpayer's failure to file the required annual report, Taxpayer's failure to file audited financial statements, and Taxpayer's failure to make the required annual renewal payment.

When the right to receive an amount becomes fixed, the right accrues. Spring City Foundry Co. v. Commissioner, 54 S.Ct. 644 (1934). If income is properly accruable under the all-events test, accrual may not be postponed merely because of a possibility that the income may have to be returned or may be subject to diminution or offset. Rev. Rul. 58-474, 1958-2 C.B. 158. The terms of an agreement are relevant in determining when the all events test is met. Decision, Inc. v. Commissioner, 47 T.C. 58 (1966), acq. 1967-2 C.B. 2.

In applying the all-events test, courts have distinguished between conditions precedent, which must occur before the right to income arises, and conditions subsequent, the occurrence of which will terminate an existing right to income, but the presence of which does not preclude accrual of income. Charles Schwab Corp. v Commissioner, 107 T.C. 282. A condition subsequent does not change the character of a transaction and does not prevent an accrual basis taxpayer from accruing income. Generally, a condition that is within the control of the taxpayer or involves a future event that is routine or ministerial in nature will be deemed a condition subsequent. In contrast to a condition subsequent, a condition precedent must be satisfied for a transaction of an accrual basis taxpayer to be completed. See Dally v. Commissioner, 227 F.2d 724 (9th Cir. 1955) (contractor's right to income was in the year it delivered a house, not in a later year when a properly certified invoice was submitted, even though the contract specifically provided for payment upon the submission of a properly certified invoice), Rev. Rul. 98-39 (accrual method manufacturer's liability to pay a retailer for cooperative advertising services is incurred in the year the services are performed, not when the required claim form is submitted), Continental Tie and Lumber Co., 286 U.S. 290 (income may not be deferred after the right matures even though a ministerial act occurs in the subsequent year). See also Ringmaster, Inc. v. Commissioner, T.C.Memo. 1962-187 (inspection and testing required by the government prior to final acceptance of merchandise, operated to create a condition precedent which prevented a sale from being completed until the condition was satisfied).

Since Taxpayer met the 50 % milestone prior to Year 4, the amount of PTCs utilized by its certified investors prior to Year 4, were no longer subject to recapture. The amount of PTCs to be utilized by the investors after January 1, Year 4, could not be forfeited or recaptured, unless, as discussed above, the Taxpayer was decertified before Date 5. Therefore, by the virtue of recognizing the tax credit offsets on Date 1 and Date 2 as scheduled payments of principal and interest on the notes, the Taxpayer has received income in Year 3[6]. Under the all-events test, the amount received is fixed in Year 3. The potential failure to file required reports or pay the annual renewal fee prior to Date 5 represent conditions subsequent which do not preclude the accrual of income. Furthermore, these conditions are clearly ministerial in nature and do not prevent the recognition of income in Year 3. Thus, the amount received in Year 3 is includible in Taxpayer’s gross income in that year.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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[6] The agents are concerned whether the amount of income realized and recognized is dependent upon the amount of PTCs utilized by the certified investors. That is not an issue in this case because the terms of the notes provide that repayment via tax credits offsets is not postponed due to the investors’ failure to use the PTCs.