

**Office of Chief Counsel  
Internal Revenue Service  
Memorandum**

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to: Revenue Agent Stephanie L. Tucker  
RFPH, Territory 2, Team 1532, Chicago  
(Large Business & International)

from: Associate Area Counsel (Chicago, Group 2)  
(Large Business & International)

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subject: Bank Enterprise Award payment received from the U.S. Department of the Treasury Community Development Financial Institutions Fund is not excluded from Taxpayer's income under section 118.

This memorandum responds to your request for assistance. This advice may not be used or cited as precedent. This advice has been coordinated with Industry Counsel, Section 118 and the National Office, Associate Chief Counsel for Passthroughs and Special Industries, Branch 5.

**LEGEND**

Taxpayer =  
Sub =  
a =  
b =  
c =  
d =  
e =  
f =  
g =  
h =  
i =

## ISSUE

Whether Bank Enterprise Award (“BEA”) payments received by Taxpayer from the U.S. Department of the Treasury Community Development Financial Institutions Fund (the “Fund”) during the taxable years ended \*\*\* a and \*\*\* b are excluded from Taxpayer’s gross income for the taxable years \*\*\* c and \*\*\* d, respectively, as a nonshareholder contribution to capital under section 118?

## CONCLUSION

It is our opinion that the BEA payments received by Taxpayer from the Fund during the taxable years ended \*\*\* a and \*\*\* b are not excluded from Taxpayer’s gross income under section 118 for the taxable years \*\*\* c and \*\*\* d, respectively. For the award years \*\*\* c and \*\*\* d, it is clear that the intent of the BEA program was to increase financial services in distressed communities. The criteria for receipt of the BEA payment, the mechanisms used to calculate the amount of the BEA payment, and the unrestricted use of the funds suggest that the purpose of the BEA payment is to supplement revenue of the recipient for qualified activities. Further, under an analysis of the factors outlined in Chicago, Burlington & Quincy R.R., the BEA payment does not satisfy the characteristics of a nonshareholder contribution to capital under section 118. Accordingly, it is our opinion that the BEA payments are properly included in Taxpayer’s gross income under section 61 for the taxable years \*\*\* c and \*\*\* d.

## FACTS

Taxpayer is a holding company subject to regulation by the Federal Reserve Bank. Taxpayer’s wholly owned subsidiary, Sub, is an FDIC-insured financial institution with offices located in the \*\*\* e metropolitan area. Taxpayer files a consolidated Federal income tax return on the cash basis of accounting.

### **General Background of the BEA Program**

The Bank Enterprise Award (“BEA”) program was established under the Community Development Banking and Financial Institutions Act of 1994, as amended, 12 U.S.C. 4701 *et seq.*, 108 Stat. 2163, 2179 (1994),<sup>1</sup> and its associated regulations codified at 12 CFR Part 1806. The BEA program is administered by the U.S. Department of the Treasury Community Development Financial Institutions Fund (the “Fund”) with its purpose to encourage FDIC-insured financial institutions to increase their levels of loans, investments, services and technical assistance within distressed communities. The Fund also encourages financial assistance to community

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<sup>1</sup> Amending the Bank Enterprise Act of 1991, 105 Stat. 2308 (1991).

development financial institutions through grants, stock purchases, loans, deposits and other forms of financial and technical assistance.

The BEA program encourages FDIC-insured financial institutions to open new savings accounts, provide home mortgage loans, and invest in small businesses in economically distressed communities. Qualifying deposits must be committed for a term of at least three years and either be (1) uninsured or (2) insured but provided at an interest rate that the Fund determines to be materially below market rates.<sup>2</sup> 72 Fed. Reg. 189, 194 (Jan. 3, 2007). Distressed community financing activities include affordable home mortgage loans, affordable housing development loans and project investments, commercial real estate loans and project investments, and small business loans. 12 CFR § 1806.103(u). Affordable housing loans finance the purchase or improvement of a borrower's primary residence and are secured by such property. 12 CFR § 1806.103(c). Affordable housing development loans finance the acquisition or development of single or multi-family residential real property where at least sixty percent of the units are sold or rented to low and moderate-income individuals. 12 CFR § 1806.103(b). Commercial real estate loans are used to finance the acquisition, development or rehabilitation of a building used for commercial purposes. 12 CFR § 1806.103(l). A small business loan is made for commercial or industrial activities to a business or farm that meets either the eligibility standards of the Small Business Administration's Development Company or Investment Company programs or has gross annual revenues of \$1 million or less. 12 CFR § 1806.103(o).

### **Calculation of the BEA Payment**

Financial institutions apply for a BEA payment on an annual basis. The BEA payment is based solely on an applicant's increase in equity investment, lending and deposit activities in distressed communities from the prior award year. A BEA applicant, such as Taxpayer, calculates and submits to the Fund an estimated award amount as part of the BEA program application. 12 CFR § 1806.202(a). The estimated award amount is based upon an award percentage for each category of qualifying activities multiplied by the increase from the prior award year in the weighted value of such category of qualifying activities. 12 CFR § 1806.202(c). The categories of qualifying activities and their corresponding measurement of value are defined in the regulations and the Notice of Funds Availability (the "NOFA") for the years at issue. 12 CFR § 1806.201; 72 Fed. Reg. at 194. The Fund establishes the award percentage for each category of qualifying activities in the NOFA. 12 CFR § 1806.202(b).

If sufficient funding exists for all estimated awards submitted by all BEA applicants and the applicants meet the other requirements for payment, the actual BEA payment may be disbursed in the amount as calculated by the BEA applicant. 12 CFR § 1806.203(a). However, where insufficient funding exists for all estimated awards

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<sup>2</sup> A materially below market interest rate is an annual rate that does not exceed 100 percent of the rate on a U.S. Treasury bill of comparable maturity as of the date of the deposit. 72 Fed. Reg. at 190-91.

submitted, the Fund determines the actual BEA payment to be disbursed to each BEA applicant based upon the priority ranking for each category of qualifying activities and the incremental increase in the value of such qualifying activities from the prior award year. 12 CFR § 1806.203(d). The priority ranking for each category of qualifying activities is described in the regulations and the NOFA. 12 CFR § 1806.203(c); 72 Fed. Reg. at 194. The NOFA establishes priority factors for only the distressed community financing activities category. 72 Fed. Reg. at 194. The NOFA assigns a priority factor of 3.0 to affordable housing loans and small business loans. Id. The NOFA assigns a priority factor of 2.0 to affordable housing development loans and commercial real estate loans. Id. The priority factor is multiplied by the increase in the corresponding qualified activities from the prior award year to achieve a weighted value. Id. The weighted value is then multiplied by the appropriate award percentage to calculate the estimated BEA payment for the qualifying activities.

During the years at issue, the estimated awards submitted by all BEA program applicants exceeded the actual funding. For the award years \*\*\* c and \*\*\* d, the award percentage for qualifying distressed community financing activities engaged in by Taxpayer during the years at issue was nine percent of the weighted value of the increase in such qualifying activities from the prior award year. 72 Fed. Reg. at 194. For the award year \*\*\* d, the award percentage for support activities, including deposits and technical assistance to a community development financial institution, was eighteen percent of the value of the increase in the qualifying activity from the prior award year. Id.

### **Terms and Conditions of the BEA Payment**

During \*\*\* c, the Fund made BEA payments of approximately \$11 million to \*\*\* f banks and thrifts across the country. During \*\*\* d, the Fund made BEA payments of approximately \$20 million to \*\*\* g banks and thrifts across the country. During the taxable years \*\*\* c and \*\*\* d, the BEA payments were not required to be used for any specific purpose.

The BEA payment is made in the form of a grant. 72 Fed. Reg. at 192. The BEA payment is unilaterally prescribed by the Fund. 12 CFR § 1806.203(f); 72 Fed. Reg. at 192, 195. The Fund has complete discretion as to the amount and recipient of a BEA payment. 72 Fed. Reg. at 195. The Fund's decision with respect to the BEA payment is final and not appealable. Id. After being selected for a BEA, the applicant must sign a Notice of Award and Award Agreement prior to the disbursement of the BEA payment by the Fund. 12 CFR § 1806.300.

### **Activities of Taxpayer**

Among its other activities, Taxpayer, through Sub, makes loans in distressed communities. During the taxable years \*\*\* c and \*\*\* d, Taxpayer applied to the Fund for a BEA based primarily upon its distressed community financing activity, including

affordable housing loans, commercial real estate loans and small business loans in distressed communities in \*\*\* e. For the taxable year \*\*\* c, Taxpayer did not supply information in support of a BEA for the other two qualifying activities, consisting generally of support activities, including deposits and technical assistance to a community development financial institution, and financial service activities provided to low- and moderate-income residents. For the taxable year \*\*\* d, Taxpayer engaged in some support activities in the form of deposits and technical assistance to a community development financial institution and provided information in support of a BEA for such activity. Taxpayer did not supply information regarding financial service activities provided to low- and moderate-income residents for the taxable year \*\*\* d.

Taxpayer calculated an estimated BEA payment for each of the years \*\*\* c and \*\*\* d in the BEA application that was submitted to the Fund. For each respective year at issue, the estimated BEA award with respect to Taxpayer's qualifying distressed community financing activities was calculated by multiplying the award percentage of nine percent by the incremental increase in the weighted value of such qualifying activities for the award year. The weighted value was determined by multiplying the change in value of the qualifying activity for the award year by the associated priority factor. The estimated BEA award with respect to Taxpayer's qualifying equity investment technical assistance activities was calculated from the incremental increase in such qualifying activities for the year multiplied by the eighteen percent award percentage.

After submitting the BEA applications for each of the years \*\*\* c and \*\*\* d, Taxpayer had no further communication with the Fund, other than the execution of the Notice of Award and Award Agreement for each year and receipt of the respective BEA payment. In \*\*\* c, Taxpayer received a BEA payment in the amount of \$ \*\*\* h from the Fund. A Form 1099-G was issued by the Fund to Taxpayer in the amount of \$ \*\*\* h for the taxable year ended \*\*\* a. In \*\*\* d, Taxpayer received a BEA payment in the amount of \$ \*\*\* i from the Fund. A Form 1099-G was issued by the Fund to Taxpayer in the amount of \$ \*\*\* i for the taxable year ended \*\*\* b.

Taxpayer used the BEA payments for general expenses and to provide additional equity investment, lending and deposit activities in distressed communities. Taxpayer did not use the BEA payments to fund any capital improvements. For financial accounting purposes, Taxpayer accounted for its receipt of the BEA payments by debit to its general revenue account and credit to its retained earnings account in the amount of the BEA payment for each of the years \*\*\* c and \*\*\* d. For tax purposes, Taxpayer treated the BEA payments as a nonshareholder capital contribution under section 118 and excluded it from gross income for each of the taxable years ended \*\*\* a and \*\*\* b. Taxpayer did not reduce the basis of any assets under section 362(c) with respect to the BEA payments received during the taxable years \*\*\* c and \*\*\* d.

## DISCUSSION

Section 61 and Treas. Reg. § 1.61-1 provide that gross income means all income from whatever source derived, unless excluded by law. Section 118(a) provides that, in the case of a corporation, gross income does not include a contribution to the capital of the taxpayer. Treas. Reg. § 1.118-1 provides, in part, that section 118 applies to contributions to capital made by a person other than a shareholder. Section 362(c)(2) requires a basis reduction in a corporation's property when the corporation receives money from a nonshareholder as a contribution to its capital.

### **History of the Supreme Court's Jurisprudence**

In general, the exclusion from gross income provided under section 118 applies to subsidies intended as reimbursements for capital expenditures. Edwards v. Cuba Railroad Co., 268 U.S. 628 (1925). In contrast, payments motivated to guarantee operating income (or compensate for losses in income) are income, and therefore, not excludable under section 118. Texas & Pacific Railway v. U.S., 286 U.S. 285 (1932); Continental Tie & Lumber Co. v. U.S., 286 U.S. 290 (1932).

In addition, the exclusion from gross income provided under section 118 does not apply to money or property transferred in consideration for goods or services rendered. In Detroit Edison v. Commissioner, the Supreme Court held that payments by customers to an electric utility corporation to extend utility service to customers' homes were not capital contributions and, instead, constituted taxable income. 319 U.S. 98, 102 (1943). Conversely, payments made by a community group to locate a factory in a community without an expectation of direct service were held to be capital contributions. Brown Shoe Co. v. Commissioner, 339 U.S. 583, 591 (1950).

In its most recent case on the subject, the Supreme Court held that "the intent or motive of the transferor...determined the tax character of the transaction." U.S. v. Chicago, Burlington & Quincy R.R., 412 U.S. 401, 411 (1973). The Supreme Court reasoned that "the decisional distinction between Detroit Edison and Brown Shoe Co. rested upon the nature of the benefit to the transferor, rather than the transferee". Id. The Supreme Court also identified five characteristics of a nonshareholder contribution to capital: (1) the contribution must become a permanent part of the transferee's working capital structure; (2) the contribution must not be compensation for specific, quantifiable service provided; (3) the contribution must be bargained for; (4) the contributed asset must foreseeably result in benefit to the transferee in an amount commensurate with its value; and (5) the contributed asset will be ordinarily employed in or contribute to the production of additional income and value assured in that respect. Id. at 413.

### More Recent Decisions Addressing Transferor Intent or Motive

In U.S. v. Coastal Utilities, Inc., 483 F. Supp. 2d 1232 (S.D. Ga. 2007), aff'd, 514 F.3d 1184 (11<sup>th</sup> Cir. 2008), the court held that government payments to a telecommunications provider for services provided in high cost areas were not capital contributions under section 118. Based upon its analysis of the mechanisms used to calculate the amount of the payments at issue, the court determined that the purpose of the payments was to supplement income. Id. The court reasoned that although the amount of the payments were largely based on investment expenditures, the calculations also took into consideration revenue requirements and expenses unrelated to investment expenditures. Id. at 1241-42. The court rejected the taxpayer's argument that the government received a direct benefit in return for the payment as "it does not follow that a government payment is a contribution to capital every time a public purpose is in some way implicated...all government spending should, theoretically, and at least indirectly, be for the purpose of benefiting the community." Id. at 1245. Lastly, the court reasoned that the payments were intended to provide an enhanced return on investments previously made, as opposed to payments to make capital investments. Id. at 1246-48.

A Florida district court recently held that "takeout bonus" payments made by the State of Florida to insurers for assuming property insurance risks were non-shareholder contributions to capital and excluded from gross income. Southern Family Insurance Company v. U.S., No. 8:05-cv-2158-T-30MAP, 2010 WL 4974612 (M.D. Fla. Dec. 1, 2010). The court in Southern Family found as fact that the "takeout bonus" payments to the insurers for assuming property insurance risks were not based on any consideration of, or desire to provide, increased revenue or return on the insurers' investments. Id. at \*1. The court observed that the amount of the "takeout bonus" payments did not depend on the value of the insured property, the insurance premium, or the insurer's expected profit from the policy. Id. The court looked to the applicable Florida statute authorizing the "takeout bonus" payments in finding that the payments were intended by the legislature to be contributions to the insurer's capital, not income. Id. at \*6. Moreover, the evidence established that the insurers and the State of Florida engaged in negotiations concerning the "takeout bonus" payment arrangements. Id. at \*7. Finally, under the specialized accounting principles applicable to insurance companies, the taxpayer in Southern Family was required to report the "takeout bonus" payments as a credit to its capital and surplus account, and not as an item of income or revenue. Id. at \*6.

In AT&T, Inc. v. U.S., No. 09-50651, 2011 WL 9729 (5<sup>th</sup> Cir. 2011), the court held that the payments were designed to supplement income. Similar to Coastal Utilities, the Fifth Circuit in AT&T, Inc. examined the policies and mechanisms used to calculate the disbursement amounts. In so doing, the Fifth Circuit determined that the payments were intended to "offset" recipients' increased cost or lost revenue. Id. at \*14. The court held that under a "transferor intent" analysis of the factors outlined in Chicago,

Burlington & Quincy, supra, the support payments were not intended to be capital contributions. Id. at \*20. The taxpayer failed to demonstrate that it “bargained for” the payments as the taxpayer merely accepted the unilaterally imposed law and regulations determining the payments. Id. at \*20-21. Further, the taxpayer demonstrated only that it participated in the development of the underlying payment program through lobbying and advocacy activities. Id. at \*21. The Fifth Circuit also found that the payments were compensation for services and that the payment program was the conduit for such compensation. Id. at \*21-24. Lastly, the taxpayer failed to demonstrate that the payments became a permanent part of its working capital structure as the program did not provide payments exclusively for the specific purpose of making capital improvements. Id. at \*24.

### **Analysis of the Intent Underlying the BEA Payments**

It is our opinion that the BEA payments are not excludable from Taxpayer's income as nonshareholder capital contributions under section 118. The criteria for receipt of an award, the mechanisms used to calculate the amount of the BEA payment at issue, and the unrestricted use of the funds suggest that the BEA payments are not properly viewed as nonshareholder capital contributions under section 118.

It is also our opinion that the BEA payments are not intended exclusively for the specific purpose of making capital improvements. The BEA program placed no restrictions or limitations on the recipient's use of the BEA payments received. In addition, the issuance of a Form 1099-G to Taxpayer by the Fund reflects the intent to treat the BEA payments as income and not contributions to capital. Further, Taxpayer did not use the BEA payments to fund any capital improvements or acquire any capital assets. Instead, Taxpayer used the BEA payments for general expenses and to provide additional equity investment, lending and deposit activities in distressed communities. For financial accounting purposes, Taxpayer debited general revenue and credited retained earnings in the amount of the BEA payments.

We have not identified any evidence to indicate that the BEA payments were intended to compensate or reimburse Taxpayer solely for any capital investments or improvements. It is our opinion that based upon the information provided, the Fund's motivation for making the BEA payment was to supplement Taxpayer's operating income, thereby creating an incentive for Taxpayer to expand investment, lending and deposit activities in distressed communities.

We also note that this case is factually distinguishable from Southern Family, supra. The BEA payments at issue are calculated based upon the increased value of the applicant's qualifying activities to provide an incentive for sustained investment, lending and deposit activities in distressed communities. As reflected in the NOFA, Taxpayer's assistance through deposits to a community development financial institution must be uninsured or provided at an interest rate that is materially below market rates. This reflects an intent to provide a supplemental return on an investment



with a higher risk (if uninsured) or a lower return (if made at a below market interest rate). The BEA payments are also distinguishable from Southern Family because Taxpayer did not have any contact with the Fund or engage in any negotiations with the Fund. The BEA payments are unilaterally prescribed by the Fund. See 12 CFR § 1806.203(f); 72 Fed. Reg. at 192, 195. Moreover, unlike in Southern Family, Taxpayer accounted for its receipt of the BEA payments in its financial accounting records by debiting its general revenue account and crediting its retained earnings account in the amount of the BEA payment for each of the years \*\*\* c and \*\*\* d. The taxpayer in Southern Family was subject to strict accounting requirements and treated the payment as a capital contribution on its financial statements.

### **Analysis under Chicago, Burlington & Quincy R.R.**

It is also our opinion that Taxpayer does not satisfy four of the five characteristics of a nonshareholder contribution to capital, as established by the Supreme Court. The remaining characteristic is immaterial as the BEA payment was made in cash and, thus, benefitted Taxpayer in the amount of the BEA payment. See TAM 9238007 (June 10, 1992). Therefore, it is our opinion that the BEA payments received by Taxpayer during the taxable years \*\*\* c and \*\*\* d are not excluded from gross income under section 118.

First, the BEA payments did not become a permanent part of Taxpayer's working capital, nor were the BEA payments used by Taxpayer for the acquisition of any capital assets. Taxpayer accounted for the receipt of the BEA payments by increasing its general revenue account. Taxpayer used the BEA payments to pay current operating expenses. The BEA payment cannot qualify as a contribution to capital where it is used for operating expenses as any other operating revenue would be used. Texas & Pacific Railway Co. v. U.S., 286 U.S. 285, 290 (1932). Taxpayer's use of the BEA payments to pay operating expenses merely subsidized its current operations. Therefore, the BEA payments did not become a permanent part of Taxpayer's working capital structure.

Second, the BEA payments were payments for specific services provided. Our conclusion is based upon the aforementioned criteria established by the Fund for receipt of a BEA payment, the mechanisms employed to calculate the amount of BEA payments, the lack of restrictions on the use of the BEA payments by recipients, Taxpayer's increase of its general revenue account for receipt of the BEA payments, and the issuance of Forms 1099-G. As discussed above, it is our opinion that the BEA payments were intended to supplement Taxpayer's operating revenue in exchange for providing banking activities in distressed communities. While a public benefit is clearly derived from the BEA program, it is our opinion that the BEA program was merely a conduit by which financial institutions are compensated for qualifying activities in distressed communities.

Third, there is no evidence of any bargaining relative to the BEA payments. The amount of the BEA payment is unilaterally prescribed by the Fund without any negotiation between the parties. The BEA payment is based upon Taxpayer's increase

in equity investment, lending and deposit activities in distressed communities from the prior award year. In Chicago, Burlington & Quincy R.R., the Supreme Court held that government subsidies to construct improvements, including overpasses, crossings and signage, were not contributions to the taxpayer's capital as the payments were not in any real sense bargained for by the taxpayer. 412 U.S. at 413-414. Moreover, the Fund has complete discretion as to the amount of any BEA payment made to Taxpayer.

Finally, the BEA payments were not employed in or contribute to the production of additional income. During the taxable years \*\*\* c and \*\*\* d, the BEA payments could be used for any purpose and were not exclusively restricted to the acquisition of capital assets or the making of capital investments. Taxpayer's use of the BEA payments to pay operating expenses and its failure to invest the BEA payments in any capital assets precludes the generation of additional income from the BEA payments.

### **Application of Section 362**

Even assuming that Taxpayer could show that the BEA payments satisfy the requirements for exclusion under section 118, Taxpayer failed to reduce the basis of any assets in accordance with section 362. If a contribution to capital has been made under section 118, then the basis of the contributed property in the hands of the taxpayer must be determined. A contribution of property other than money by a nonshareholder to the capital of a corporation will result in the property having a basis of zero. I.R.C. § 362(c)(1). In the event that money is contributed by a nonshareholder, then any property acquired with the money during the following 12 months shall have its basis reduced by the amount of the contribution. I.R.C. § 362(c)(2). Here, Taxpayer did not reduce the basis of any assets under section 362(c) but now argues that it should have reduced the basis of loans it issued during the years at issue. Notwithstanding the question of whether Taxpayer can reduce the basis of loans, it is clear that the Taxpayer did not comply with section 362(c).

For the foregoing reasons, it is our opinion that the BEA payments made to Taxpayer by the Fund during the taxable years ended \*\*\* a and \*\*\* b do not satisfy the requirements to be treated as a nonshareholder contribution to capital under section 118. The criteria for receipt of the BEA payment, the mechanisms used to calculate the amount of the BEA payment, and the unrestricted use of the BEA funds suggest the purpose of the BEA payment is to supplement revenue of the recipient for qualified activities. Further, the BEA payments do not satisfy the characteristics of a nonshareholder contribution to capital as established by the Supreme Court. Therefore, the BEA payments are not excluded from Taxpayer's gross income under section 118. Accordingly, it is our opinion that BEA payments are includible in Taxpayer's gross income in the amount of the BEA payments received during the taxable years ended \*\*\* a and \*\*\* b.

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Please contact me directly at \_\_\_\_\_ if you have any further questions.

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cc: