

April 21, 2015

Memorandum in Support of Position That IRS Should Issue Revenue Ruling
Confirming That Green Infrastructure Rebates are Not Taxable

Summary

Pollution from stormwater overflow is a growing problem for U.S. cities. One of the solutions is the installation of “green infrastructure,” such as green roofs, cisterns or permeable pavement, to enhance the absorption capacity of the natural landscape. In order to encourage green infrastructure installation on private property, regional water utilities and municipal water departments have begun offering rebates to private property owners who install green infrastructure projects.

These green infrastructure rebates should not be taxable to the recipients both because the rebates should be treated as a purchase price reduction (and therefore as not taxable) and because the rebates do not confer a net benefit on the property owner (and therefore do not constitute a taxable accretion to wealth). The IRS should confirm this result in a revenue ruling. If the IRS were to issue such a ruling, water utilities could forebear from issuing Forms 1099 in connection with the rebates, which would make property owners more willing to participate in these green infrastructure programs.

I. Background

Protecting waterways from stormwater runoff pollution is an issue of rising concern and cost for US municipalities. The amount of developed land in the US increased 56% between 1982 and 2007¹ and each year 800,000 acres of additional land is consumed by new development.² Land development is often accompanied by increased amounts of impervious surface, as natural landscapes are transformed into hard surfaces (such as roads, driveways, and rooftops) that reduce natural water absorption capacity. As a result, urban growth increases stormwater runoff during rain events, as water that is no longer able to soak into the ground is directed into local storm sewer systems, collecting a range of pollutants from streets, sidewalks and lawns along the way. These elevated stormwater flows lead to rapid flows of polluted stormwater or combined storm water/wastewater flows into local waterways, degrading local water quality and presenting a public health threat.

In an effort to reduce the impact of stormwater runoff on urban waterways, water departments and utilities, which have the responsibility to protect waterways from stormwater pollution and combined sewer overflows under sections 402 (p) and 402 (q) of the Clean Water Act, have begun to invest in on-site stormwater retention, detention, and infiltration using green

¹ U.S. Department of Agriculture (2009). “Summary Report: 2007 National Resources Inventory,” prepared by the Natural Resources Conservation Service and Center for Survey Statistics and Methodology, Iowa State University, accessed at http://www.nrcs.usda.gov/Internet/FSE_DOCUMENTS//stelprdb1041379.pdf, p. 11.

² U.S. Environmental Protection Agency. Clean Water Act’s Stormwater Program Presentation. Accessed at: http://www.epa.gov/npdes/pubs/sw_rule_presentation_July_2013.pdf.

infrastructure (GI). Recognizing that a sizable proportion of urban land is privately owned, local water utilities and departments have launched GI rebate programs to encourage private property owners to install GI assets. Rebates are made for the installation of GI projects, such as rain gardens, green roofs, cisterns, planter boxes, or permeable pavement, that re-create or enhance natural absorption and infiltration capacity. Payments under the local GI rebate programs typically cover between 30-100 percent of GI project costs. These rebate programs are structured to reduce the cost of private property-based green infrastructure projects, in order to encourage property owners to install green infrastructure projects that would otherwise be uneconomic to install.

For example, in Seattle, Seattle Public Utilities has established the *Rainwise* program, under which property owners who install rain gardens or cisterns obtain rebates for approximately 80 to 100 percent of project costs.³ The average rebate for rain gardens, the most costly of the eligible *Rainwise* projects, is \$4,400. Similarly, the Milwaukee Metropolitan Sewerage District's *Green Infrastructure Partnership Program* will pay up to 50% of the cost of capturing stormwater onsite, with reimbursement amounts set at a specific rate per type of GI installation.⁴

Water departments and utilities have implemented GI rebate programs because they have determined that it can be less expensive to subsidize green infrastructure installations on private property than to manage stormwater exclusively in the public right of way. Private property owner installation of GI would therefore reduce the utilities'-- and thus ratepayer -- costs of protecting local water quality and complying with the Clean Water Act. The rebates are designed to encourage the installation of needed stormwater infiltration capacity in the form of GI that otherwise would not be made by the property owners because of cost considerations. There is no intent to confer a benefit on the property owner, only an intent by the local authority to manage stormwater runoff in the most cost-efficient manner.

II. Obligations of Water Utilities under Clean Water Act and How Green Infrastructure Rebates Further Clean Water Act Compliance.

Municipalities have compliance obligations pursuant to the Clean Water Act, 33 U.S.C. Sections 1251 through 1357, with respect to managing stormwater. In this regard, the installation of green infrastructure has been specified by the EPA as an important means of Clean Water Act compliance.

A central objective of the Clean Water Act is to prevent raw sewage and pollutants carried by stormwater from entering our nation's waterways. Under Sections 402(p) and 402(q), the EPA and the states are charged with regulating discharges of polluted stormwater and sewage overflows into local water bodies through the National Pollutant Discharge Elimination System (NPDES). Under NPDES, municipal stormwater and sewage discharges are treated as point source pollution and are required to be covered by a NPDES permit. To comply with NPDES permit obligations, operators of combined sewer systems (which handle sanitary sewage and

³ Seattle.gov Rain Wise Tools Home, Accessed at <https://rainwise.seattle.gov/city/seattle/overview>

⁴ Milwaukee Metropolitan Sewerage District. *MMSD Green Infrastructure Partnership Program Portal*. Accessed at : <http://www.freshcoast740.com/Learn/Funding-Programs/GI-Partnership-Program>

stormwater in a single set of pipes) must develop Long Term Control Plans (LCTPs) that achieve compliance with federally-approved water quality standards through reductions in combined sewer overflows. Similarly, municipal separate storm sewer system (MS4) operators are required to develop and implement programs to protect water quality and the designated uses of local waterbodies through reductions in polluted stormwater runoff.

Traditionally, local sewer and stormwater authorities have attempted to reduce the impact of these pollution sources through the construction of so-called gray infrastructure – e.g., underground storage tunnels, pipes, gutters, wastewater treatment plants, and stormwater detention basins – systems that are designed to convey rainwater away from the place where it falls. Gray systems can be very costly to implement, and existing gray infrastructure in older cities is often overwhelmed by the runoff produced by the region’s impervious area. As an alternative to gray infrastructure, local water authorities have begun to invest in enhancing the on-site stormwater management capacity of their urban/suburban landscapes using green infrastructure. Green infrastructure, as defined by EPA, is infrastructure that uses natural and engineered solutions to mimic a landscape’s natural ability to infiltrate, evapotranspire and reuse stormwater where it falls.⁵

In April, 2007, the EPA entered into a formal agreement with state environmental and wastewater utility groups, formalizing the use of green infrastructure solutions to reduce combined sewer overflows and stormwater pollution.⁶ As part of that agreement, the EPA committed to “developing memoranda and guidance materials, including language for the NPDES permit writer’s manual, that would explain how regulatory and enforcement officials should evaluate and provide appropriate credit for the use of green infrastructure in meeting Clean Water Act requirements.” The EPA has since developed a Green Infrastructure Strategic Agenda⁷ as well as a series of guidance documents entitled the “Green Infrastructure Permitting and Enforcement Series,” which provides EPA and state permitting and enforcement partners with direct guidance on how GI approaches can be integrated into NPDES wet weather programs.⁸ In addition, the EPA and its state partners have negotiated 17 consent decrees with local stormwater authorities that authorize the use of green infrastructure approaches within their enforcement settlement.⁹

Thus, the use of green infrastructure is not only a cost-effective way of addressing polluted stormwater runoff and sewage overflows but also an important part of municipal compliance with Sections 402(p) and 402(q) of the Clean Water Act.

⁵ U.S. Environmental Protection Agency. Use of Green Infrastructure in NPDES Permits and Enforcement. Memorandum, August 16, 2007. Accessed at: http://water.epa.gov/infrastructure/greeninfrastructure/upload/gi_memo_enforce.pdf.

⁶ U.S. Environmental Protection Agency, et al. Green Infrastructure Statement of Intent. April 19, 2007. Accessed at: http://water.epa.gov/infrastructure/greeninfrastructure/upload/gi_intentstatement.pdf

⁷ U.S. Environmental Protection Agency. Green Infrastructure Strategic Agenda 2013. Accessed at: http://water.epa.gov/infrastructure/greeninfrastructure/upload/2013_GI_FINAL_Agenda_101713.pdf

⁸ United States Environmental Protection Agency. Green Infrastructure Permitting and Enforcement Series. http://water.epa.gov/infrastructure/greeninfrastructure/gi_regulatory.cfm.

⁹ U.S. Environmental Protection Agency, Enforcement Settlements including Green Infrastructure components. Accessed at: <http://water.epa.gov/infrastructure/greeninfrastructure/enforcement.cfm>

III. Tax Issue with Green Infrastructure Rebates

The principal tax issue in connection with these programs is whether the rebate payments are taxable income to the property owner. Lacking clear authority that the rebate payments are nontaxable, many utilities issue Forms 1099 to GI rebate recipients, thereby discouraging participation in their GI programs. If the Internal Revenue Service would issue a revenue ruling clarifying that such rebates are not taxable, utilities believe participation in their rebate programs would increase significantly, thereby furthering private property green infrastructure development.

IV. Why Green Infrastructure Rebates Should Not be Taxable.

There are two principal reasons why the GI rebates should not be taxable: (i) the rebates are in effect purchase price reductions (not income), and (ii) the rebates provide no net benefit to the property owner. We discuss each of these reasons in more detail below.

Purchase Price Reduction. A rebate made to a purchaser of property is treated as a reduction of the purchase price (basis), rather than taxable income. See, e.g., Pittsburgh Milk Co. v. Commissioner, 26 T.C. 707 (1956). This principle can apply in situations where, as here, the payor of the rebate is not the seller of the property. In Revenue Ruling 76-96, 1976-1 C.B. 23, *suspended in part on another issue*, Rev. Rul. 2005-28, 2005-1 C.B. 1997, the IRS held that, in the case of a retail purchase of an automobile from a dealership, a rebate paid to the retail customer by the manufacturer (rather than by the car dealership) is treated as a nontaxable reduction of the purchase price (and not as taxable income).

The “reduction of purchase price” principle has been specifically applied to government payments. In Revenue Ruling 88-95, 1988-2 C.B. 28, *clarified by* Rev. Rul. 2001-8, 2001-1 C.B. 726, Congress had authorized the Commodity Credit Corporation (CCC) to make “first handler payments” with respect to upland cotton produced in the U.S. and purchased by certain persons in the business of purchasing and selling upland cotton. These were designed to reduce the price of domestic upland cotton to the prevailing world market price and thus encourage exports of cotton and cotton-based products. In addition, because these payments were anticipated to cause a decrease in the market value of raw cotton held in inventory, Congress authorized the CCC to make “inventory protection payments” with respect to domestically produced raw cotton held in inventory (and not eligible for the first handler payments). The IRS held that both the first handler payments and the inventory protection payments should be treated as a reduction in the cost of the cotton giving rise to the payments and were thus not includable in the gross income of the recipient, a textile manufacturer (to the extent that the payments did not exceed the cost of the cotton). Like the payments in Revenue Ruling 88-95, the GI rebates are payments by a government-related entity intended to reduce the recipient’s costs of specific property and, similarly, should be treated as a reduction of purchase price.

Third party payments have also been treated as a purchase price reduction in other contexts. In Freedom Newspapers, Inc., T.C. Memo 1977-429, a potential purchaser of several newspapers did not wish to acquire one of the newspapers in the group. In order to induce the purchaser to purchase all of the newspapers, the seller’s broker agreed to pay the potential purchaser \$100,000 if the broker could not arrange a resale of the unwanted newspaper for an amount at least equal

to the purchaser's cost within one year of the purchase. The broker was unable to arrange the sale of that newspaper within the required period (later extended to two years) and accordingly paid the \$100,000 to the purchaser. The Tax Court held that the \$100,000 payment constituted a reduction in the purchaser's cost basis in that newspaper and not income to the purchaser.

The Freedom Newspapers court relied in part on James Brown, 10 BTA 1036 (1928). In the Brown case, the majority shareholder of a coal company sought to induce a sale of a minority interest in the company to a purchaser that the majority shareholder considered friendly. The prospective purchaser considered the price to be too high, so the majority shareholder agreed to pay the purchaser a portion of certain compensation that the majority shareholder expected to receive from the coal company. The purchaser agreed to buy the minority interest on this basis and subsequently collected the agreed amount. The Court held that the payment constituted a reduction of the purchaser's cost of the shares (and not taxable income). Cf. Rev. Rul. 2008-26, 2008-1 C.B. 985 (Medicaid rebates paid by pharmaceutical manufacturers to state Medicaid agencies, equal to part of the amount state Medicaid agencies paid to retail pharmacies for covered outpatient drugs dispensed to Medicaid beneficiaries, are adjustments to the manufacturers' sales price in calculating gross receipts); Internal Revenue Code §136 (direct or indirect subsidies provided by utility to customer for purchase or installation of energy conservation measure not taxable); Rev. Rul. 91-36, 1991-2 C.B. 17 (utility customers that installed energy efficient products or equipment acquired from utility or third parties received electricity price reductions or nonrefundable credits against electricity purchases; held that price reductions and nonrefundable credits were nontaxable reductions in price of electricity).

Thus, based on Revenue Ruling 88-95, Revenue Ruling 76-96, Freedom Newspapers and Brown, the payments by the water utilities to the property owner to defray the costs of GI projects, which reduce the financial cost to the utilities of managing stormwater absorption, should be treated as nontaxable reductions of the property owner's cost of acquiring the GI projects.

One ruling that on its face seems contrary, is in fact distinguishable, Revenue Ruling 79-356, 1979-2 C.B. 28, holds that \$400 payments by states to homeowners who installed HUD-approved solar hot water systems are taxable to the homeowners. However, the taxpayers installing the solar hot water systems were eligible for an energy credit under the Internal Revenue Code as in effect at the time of the ruling. The Code provided that the credit reduced the taxpayer's basis for the system. Thus, this ruling is distinguishable in that the taxpayer was already receiving federal income tax benefits for installing the system and, if Congress intended an additional benefit, it presumably would have so specified by statute.

A private letter ruling and a technical advice memorandum conclude that certain rebate-like payments are taxable, but on facts that are quite different from those involved in GI rebates. We note, of course, that private letter rulings and technical advice memoranda are not binding authority, but we discuss them nevertheless in the interest of completeness.

In PLR 201004005 (1/29/10), in order to provide an economic stimulus for a state's economy and an unspecified industry within that state, the state established a program to offer a cash grant to purchase unspecified property (although the redacted version of the ruling does not specify the property, it would appear to be home purchases that were the subject of the grant). The ruling

holds that the grants are taxable to the recipients, qualifying neither under the exclusion for general welfare payments nor as a purchase price reduction.

The ruling discusses various authorities and states that in each of the situations described therein, “a party to the transaction took action to induce the sale of property by reducing the sales price directly (by reducing or rebating part of the sales price) or indirectly (by foregoing or rebating commissions that were dependent on the sale of the property)”. It goes on to say that grants described in the ruling “do not affect the amount received by any seller, lender, broker or other party to the purchase” and therefore do not constitute a purchase price reduction.

The GI rebate programs in question are intended to save money for the water utilities or departments by enabling them to manage stormwater more cheaply. Thus, the water utilities or departments have a financial interest in the transaction more similar to those of the parties mentioned in the PLR, and quite unlike the diffuse interest of the state in seeking to provide an economic stimulus through the cash grants in the ruling.

The technical advice memorandum, TAM 8924002 (2/29/89), addresses an electric cooperative’s payments to customers to provide an incentive for the customers to install alternative energy systems to reduce usage during peak periods. The payments were based on the estimated reduction in consumption. The TAM held that the payments were taxable. The payments were characterized as payments for services (the customer’s agreement to use an alternative heating system), not nontaxable rebates.

These payments are also distinguishable from GI rebates because the electric coop payments were not based on the actual cost of any particular alternative energy system and thus did not function as a purchase price reduction. In the case of utility and water department GI rebate programs, the rebates are tied to the expected cost of installation for each distinct GI facility. Thus, unlike under the facts of the TAM, the GI rebates reduce the cost of specific GI property to the property owner.

The TAM states that the receipt of funds can be considered a nontaxable rebate only if the rebate is based on the purchase price of the item, the manufacturer or dealer offers the rebate, and the recipient is able to negotiate or renegotiate the purchase price in an arms-length transaction. This may be intended as a statement of law applicable specifically to manufacturer/dealer rebates, but it does not encompass the broader class of payments (like those in Revenue Ruling 88-95, Freedom Newspapers and Brown) that are treated as a reduction of purchase price rather as taxable income. In any event, as noted in the preceding paragraph, the GI rebates are distinguishable from the payments involved in the TAM because the GI rebates are being made to defray the cost of specific GI installations.

Moreover, the IRS argues in both PLR 201004005 and TAM 8924002, contrary to the holdings in Revenue Ruling 88-95 and Brown, that in order for the rebate to be nontaxable, it must be provided by a direct or indirect party to the transaction, (*e.g.*, a seller, broker or lender) who gets a reduced amount from the transaction as a result of the rebate. However, the federal income tax issue is whether the rebate is an “accretion to wealth” to the recipient. In other words, the issue is whether the recipient should be treated as receiving income rather than as having acquired a specific item of property at a reduced price. The identity of the provider (whether or not a party

to the transaction) should not be relevant to the inquiry. In the case of the GI rebates, the recipient of the rebate is a property owner that acquires a rain garden, rain barrel, permeable pavement, or other specific GI assets at a reduced cost. Therefore, regardless of the payment's source, the payment functions economically as a purchase price reduction to the property owner and should be treated as such for federal income tax purposes.

No Net Benefit to Property Owner. The touchstone of taxable income is that the taxpayer receives an accretion to wealth. See Commissioner v. Glenshaw Glass, 349 U.S. 426 (1955). The GI improvements are designed to manage and reduce stormwater runoff. Any benefit to the property owner is incidental and at most commensurate with the property owner's post-rebate out-of-pocket expense. Indeed, the payments are designed to encourage GI installation that the property owners would not make in the absence of the payments. As the transaction would not confer a benefit upon the property owner in excess of the property owner's after-rebate cost, the rebate should not be taxable to the property owner.

This conclusion finds support in PLR 7950049 (9/12/79). In that ruling, Corporation wanted to construct a terminal in a state to facilitate the operation of a pipeline through that state. The state required Corporation to reduce pollution so as to provide a net benefit to local air quality. This required Corporation to remove more pollutants from the air than the proposed terminal was expected to emit. To satisfy this requirement, Corporation proposed to install two pollution control facilities on an electrical generating unit owned by an unrelated Utility. Corporation retained legal title to the pollution control facilities. The pollution control facilities installed on Utility's property would not satisfy any of Utility's pollution abatement requirements; instead it would only enable Corporation to satisfy its own pollution reduction obligations. The ruling held *inter alia* that the construction and installation of the pollution control equipment would not result in income to Utility nor would Utility be required to recognize income with respect to construction payments it received from Corporation to the extent such payments did not exceed Utility's expenditures. By analogy, the GI rebates should not be taxable to the property owners because the benefit from the rebates is derived by the water utility (*i.e.*, reducing the utility's cost burden of managing stormwater runoff and complying with the Clean Water Act) rather than by the property owner.

V. Conclusion – IRS Should Issue Favorable Revenue Ruling

In order to further the federal policies embodied in the Clean Water Act, the IRS should issue a revenue ruling confirming that green infrastructure rebates are not taxable to the recipient property owners (and that therefore the water utilities need not issue Forms 1099).

Respectfully submitted,

Milwaukee Metropolitan Sewerage District
Montgomery County, Maryland
The National Association of Clean Water Agencies
Natural Resources Defense Council
Seattle Public Utilities
U.S. Water Alliance's Urban Water Sustainability Council