



COMMISSIONER

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

November 6, 2002

The Honorable Carolyn B. Maloney
U.S. House of Representatives
Washington, D.C. 20515

Dear Ms. Maloney:

Thank you for your September 30, 2002 letter about the tax treatment of grants that governmental agencies will make to individuals and businesses affected by the World Trade Center disaster. You asked us to resolve the income tax treatment of the grants as quickly as possible.

The Secretary and I are giving the highest priority to publishing guidance on this issue. This letter summarizes well-established principles of current law on the income tax treatment of governmental grants paid to individuals and businesses. We anticipate publishing guidance that will be consistent with these principles.

Gross income generally means all income from whatever source derived and encompasses all accessions to wealth, clearly realized, over which taxpayers have complete dominion and is subject to tax unless specifically exempted [*Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955)]. The IRS has ruled, however, that payments made under legislatively provided social benefit programs for the promotion of the general welfare are not included in a recipient's gross income (Rev. Rul. 74-205, 1974-1 C.B. 20; Rev. Rul. 98-19, 1998-1 C.B. 840). To qualify, the payments must (i) be made from a governmental fund, (ii) be for the promotion of general welfare (i.e., based on need), and (iii) not represent compensation for services (Rev. Rul. 82-106, 1982-1 C.B. 103; Rev. Rul. 75-246, 1975-1 C.B. 24).

Generally, governmental grants to help individuals and families meet disaster-related expenses are treated as meeting the general welfare exclusion requirements to the extent that they reimburse extra reasonable and necessary personal, living, or family expenses incurred as a result of a disaster. Although the general welfare exclusion applies to needs-based payments, in this context, "need" does not mean financial need. As a result, the general welfare exclusion applies equally to all residents of an affected area regardless of their income levels (Rev. Rul. 76-144, 1976-1 C.B. 17; Rev. Rul. 98-19). Governmental grants to businesses do not qualify for exclusion from income under the general welfare exclusion because the exclusion is only available for payments to individuals based on individual or family need [See Rev. Rul. 80-330, 1980-2 C.B. 29 *obsoleted* by Rev. Rul. 82-195, 1982-2 C.B. 34; Rev. Rul. 76-131, 1976-1 C.B. 16;

compare Rev. Rul. 77-77, 1977-1 C.B. 11 (grants to Indians and tax-exempt Indian tribes to stimulate Indian entrepreneurship and employment qualify under general welfare exclusion)].

Under current law, individuals and businesses must include in gross income governmental grants that compensate for lost wages or lost profits (Rev. Rul. 73-408, 1973-2 C.B. 15). However, a business may have deductible business expenses or net operating losses that reduce or eliminate any resulting tax liability.

In the Victims of Terrorism Tax Relief Act of 2001 (Act), Congress added to the Internal Revenue Code a new exclusion from income for certain disaster relief payments (Section 139). Governmental grants to businesses do not qualify for exclusion from income under section 139 because that exclusion applies only to payments to individuals.

The Staff of the Joint Committee on Taxation's explanation of new section 139(b)(4), states:

As under the present law general welfare exception, the [new] exclusion does not apply to payments in the nature of income replacement, such as payments to individuals of lost wages, unemployment compensation, or payments in the nature of business income replacement.

See Staff of the Joint Committee on Taxation, *Technical Explanation of the "Victims of Terrorism Tax Relief Act of 2001," as Passed by the House and the Senate on December 20, 2001*, 16 (JCX-93-01), December 21, 2001.

Governmental grants to businesses in response to a disaster also do not qualify for exclusion from income as gifts because the government's intent in making the payments proceeds, not from a detached and disinterested generosity, but from its duty to relieve the hardship caused by the disaster [See *Kroon v. United States*, Civ. No. A-90-71, 1974 U.S. Dist. LEXIS 8656 (D. Alaska 1974)]. However, other provisions of law allow businesses to exclude governmental grants from income, depending on the facts and circumstances, the purpose of the grant, and the character of the expenditures. For example, businesses that are corporations do not include in gross income amounts (including governmental grants) received as nonshareholder contributions to capital (Section 118). These businesses are, however, required to reduce the basis of assets acquired with the amounts excluded from income. Similarly, businesses may defer recognizing gain on proceeds (including governmental grant proceeds) they receive in connection with the destruction of property, if they invest the proceeds in property similarly related in service or use to the destroyed property and reduce basis of the acquired property by the deferred gain amount (Section 1033). In addition, if property is destroyed in a Presidentially declared disaster, such as the World Trade Center disaster, businesses may use the grant proceeds to purchase any tangible business

property for any service or use and still defer the recognition of gain [Section 1033(h)(2)]. The IRS has consistently applied these principles to governmental grants to businesses, including Community Development Block Grants.

I understand that Congress may consider legislation to exclude from income payments made under New York's World Trade Center disaster relief grant programs. Under current law, taxpayers may not deduct expenses that the law requires them to allocate to tax-exempt income (Section 265). Therefore, if Congress enacts legislation to specifically exempt such payments from tax, recipients of the payments will not be able to deduct expenses they incur to carry out the specific purpose for which the payment is made. As a result, a business that spends earmarked tax-exempt grant proceeds for the intended purpose and a business that spends taxable grant proceeds on deductible expenses generally will be in the same tax position. In addition, other losses that a business suffered as a result of a disaster generally will reduce any taxable income resulting from a taxable grant.

I hope this information is helpful. I would be happy to meet with you to discuss these issues in more detail. If you have any questions, please call me or Floyd Williams at (202) 622-4725.

Sincerely,



Charles O. Rossotti