



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, DC 20224

OFFICE OF
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MEMORANDUM FOR HARRY MARTIN, FED-STATE COORDINATOR
NORTH-SOUTH CAROLINA DISTRICT

FROM: Lewis J. Fernandez
Deputy Assistant Chief Counsel
(Income Tax & Accounting)

SUBJECT: NORTH CAROLINA FLOOD RELIEF--
REPLACEMENT AND REPAIR GRANTS FOR
LOW-INCOME FAMILIES

This technical assistance request is in response to your request for assistance dated December 15, 1999, regarding the tax treatment of state payments made to individuals and businesses in North Carolina that suffered losses due to the flood damage caused by Hurricane Floyd. Technical assistance does not relate to a specific case and is not binding on Examination or Appeals. This document is not to be cited as precedent.

ISSUES:

Are payments from the State to assist low-income homeowners in replacing, repairing, or rehabilitating their flood-damaged homes includible in the homeowners' gross incomes? Is the State required to file information returns reporting the payments?

CONCLUSION:

The payments made by the State to alleviate the effects of disaster conditions on low-income homeowners are in the nature of general welfare and, in general, are not includible in the homeowners' gross incomes. However, homeowners who receive or benefit from payments under this program may be required to include an amount in income if they previously deducted the amount of the loss to which the payment relates. The State should not issue Forms 1099 to homeowners for the payments because the payments are not fixed and determinable income, but the State may be required to issue Forms 1099 to report payments to contractors who perform repair work on the property.

FACTS:

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The General Assembly of North Carolina declared Hurricane Floyd the worst natural disaster in the State's history. In the latter part of 1999, Hurricane Floyd caused extensive and prolonged flooding that devastated the civil, social, economic, and environmental well-being of eastern North Carolina. The entire economic base of that area was undermined, making it extremely difficult for individuals to earn income to support themselves and their families. In response to the widespread damage caused by Hurricane Floyd, Governor Jim Hunt, Jr. of North Carolina proposed a state emergency package consisting of numerous relief programs to assist individuals and small businesses in recovering from this disaster. The "Hurricane Floyd Recovery Act of 1999," appropriating funds for a package of relief programs, was enacted on December 16, 1999.

The following disaster assistance program is addressed in this Technical Assistance. The number appeared in the margin of materials in your request for assistance. We are providing our assistance regarding other State programs in other memoranda.

Replacement and Repair Grants For Low-Income Families (3)

This program provides relief to homeowners who (1) are not eligible for federal buy-out or Small Business Administration loans, (2) are not covered by insurance, and (3) are low income (defined as no more than eighty percent of the adjusted median income for the county or for state-wide non-metropolitan areas, whichever is greater).

Homeowners who must replace their properties may obtain funds from the State in the form of interest-free loans secured by a second mortgage on the property. No payments are required during the 10-year term of the loan, at which point the loan is forgiven if the homeowner is still living in the property. If the homeowner sells the property within 5 years the principal must be repaid at the time of sale. If the homeowner sells the property within 5 to 10 years a prorated portion of the principal is due upon sale.

The State will also provide supplemental funds to localities to repair or rehabilitate the flood-damaged homes of low-income homeowners. A locality will work with housing specialists to determine who qualifies for assistance. The locality then hires contractors or nonprofit groups to do the repair work. The housing specialists ensure that the work is done correctly. Beneficiaries under this program must repay a prorated portion of the grant if the property is sold within 5 years.

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LAW AND ANALYSIS:

Inclusion in gross income

Section 61(a) of the Internal Revenue Code and the Income Tax Regulations thereunder provide that, except as otherwise provided by law, gross income means all income from whatever source derived.

However, the Service has held that payments made under legislatively provided social benefit programs for the promotion of general welfare are not includible in an individual's gross income (the general welfare exception). For example, in Rev. Rul. 76-395, 1976-2 C.B. 16, the Service concluded that home rehabilitation grants received by low-income homeowners residing in a defined area of a city are in the nature of general welfare and are not includible in their gross income. See also Rev. Rul. 98-19, 1998-1 C.B. 840 (relocation payments funded under the same Act are not includible in an individual's gross income). Rev. Rul. 74-205, 1974-1 C.B. 20, similarly holds that replacement housing payments to assist individuals displaced by federal programs to acquire new dwellings are excludible from gross income. Certain payments made for the benefit of members of a particular group, though not made to them directly, also have been held to be in the nature of general welfare. See Rev. Rul. 75-271, 1975-2 C.B. 23.

We conclude that payments under both the Replacement and Repair programs should be analyzed as grants and not loans because the circumstances that would give rise to a requirement to repay all or part of the amount received are within the recipients' control. On that basis, we find that the Replacement and Repair programs are analogous to the programs in the rulings cited above. Accordingly, we conclude that, in general, payments under the Replacement and Repair Grants program are excluded from the income of the homeowner beneficiaries under the general welfare doctrine. However, in some cases the homeowners may be required to afford special tax treatment to the payments, as described below.

Losses deducted in a prior year

Individual homeowners who suffered flood damage to their residences and who benefit from the payments described above may have been entitled to claim deductions for casualty losses under § 165. Section 165 permits a deduction for "any loss sustained during the taxable year and not compensated for by insurance or otherwise." Section 1.165-1(d)(2)(i) of the Income Tax Regulations provides that no portion of a loss is "sustained" for purposes of a deduction under § 165 if a reasonable prospect of recovering reimbursement exists.

We view the assistance provided under the Replacement and Repair Grants Program as reimbursement for the flood losses because the assistance is "structured to replace

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what was lost.” Estate of Bryan v. Comm’r, 74 T.C. 725 (1980); Rev. Rul. 87-117, 1987-2 C.B. 61. If a reasonable prospect of recovering reimbursement existed in the year of the casualty, deductions claimed for related casualty losses were erroneous. In order to correct the error, the individuals would be required to amend the return on which the casualty loss deduction was claimed.

If no reasonable prospect of recovering reimbursement existed in the year of the casualty, then deductions in that year for casualty losses were proper. The tax benefit rule, however, might require individuals who properly claimed the casualty loss deductions to include all or a portion of the amount of the deductions in gross income when they later receive this assistance.

The tax benefit rule ordinarily requires taxpayers to include in gross income the amount of a prior year deduction when an event occurs that is fundamentally inconsistent with the premise of the deduction. See Hillsboro Nat’l Bank v. Comm’r, 460 U.S. 370 (1983). An event is fundamentally inconsistent with the premise of a deduction if the deduction would have been precluded had the event occurred in the same taxable year as the deduction. Id. Here, the “event” to be considered in reference to the casualty loss deductions is the receipt of assistance in having a home repaired, rehabilitated, or replaced. If this event had occurred in the same taxable year as Hurricane Floyd, the related casualty loss deductions would have been precluded to the extent that the assistance reimbursed the losses. Thus, the receipt of assistance is fundamentally inconsistent with the premise of a deduction under § 165, and the tax benefit rule will require a beneficiary of assistance to include in gross income the amount of the prior year deduction that does not exceed the assistance to the extent the deduction previously reduced tax. See § 111, Recovery of Tax Benefit items. Section 1.165-1(d)(2)(iii) supports this conclusion, providing that a taxpayer who has deducted a loss and in a subsequent year receives reimbursement for the loss must include the reimbursement in gross income for the taxable year in which received, subject to the provisions of § 111.

When an event that is fundamentally inconsistent with the premise of a deduction occurs in the context of an exclusionary provision, we must resolve the inherent tension between the inclusion required by the tax benefit rule and the exclusionary provision. Cf. Hillsboro, 460 U.S. 370 (nonrecognition provision and tax benefit rule). Even though the assistance qualifies for exclusion under the general welfare exception, we conclude that any inclusion required by the tax benefit rule will override the exclusionary rule. Rev. Rul. 76-144, 1976-1 C.B. 17 (relating to federally-funded grants to aid individuals unable to meet necessary expenses or serious needs as a result of a major disaster) holds that a taxpayer cannot have both the benefit of excluding money from income under the general welfare exception and claiming a deduction based on the loss for which the money compensates. It follows that individuals who receive assistance under the Replacement and Repair Grants program will be required to recognize tax benefit income to “cancel out” any deduction in a prior year for the compensated losses.

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Information reporting

Section 6041 requires all persons engaged in a trade or business and making payment in the course of the trade or business to another person of fixed and determinable gains, profits and income of \$600 or more in a taxable year to make an information return. Sections 1.6041-1(b)(1) and (g) provide that payments made by a state or a political subdivision are subject to this reporting requirement. Returns under § 6041 must be made, in general, on Forms 1096 and 1099, and a copy furnished to the person to whom the payments are made.

As used in § 6041, the term "gains, profits, and income" means gross income. Thus, a payor generally would not be required to make a return under § 6041 for payments that are not required to be included in the recipient's income.

Section 1.6041-1(c) provides that income is "fixed" when it is to be paid in amounts definitely predetermined. Income is "determinable" whenever there is a basis of calculation by which the amount to be paid may be ascertained.

We have concluded that payments under the Replacement and Repair Grants program generally will be excludible from the income of the homeowner beneficiaries. Although assistance beneficiaries may be required to include all or a part of the assistance received in income under the tax benefit rule, the State would not know whether a recipient deducted the casualty loss in a prior year or the amount of the tax benefit (if any) that taxpayer is required to include in income. Therefore, the assistance payments are not "fixed and determinable income" to the homeowner beneficiaries and are not reportable under § 6041 as to them.

In contrast, payments made to contractors or other service providers to perform repairs on the homes of assistance beneficiaries are "fixed and determinable income" and are generally reportable on Form 1099, if the amount paid to a payee in a calendar year is \$600 or more and the payee is not a corporation or political subdivision of the State. If the State or locality is performing management or oversight functions in connection with a payment to a contractor, it is considered the payor required to file Form 1099, even though the payment is being made on behalf of a homeowner who would not be required to file Form 1099. For example, in Rev. Rul. 93-70, 1993-2 C.B. 294, a bank making progress payments to a contractor from the proceeds of a construction loan was held to be performing management and oversight functions, and was required to file Forms 1099, with regard to the payments when the bank evaluated the cost of the project, ensured that the payments were properly applied so as to avoid mechanics' liens, and conducted site inspections to determine whether work had been completed.

Accordingly, we suggest that you advise the State of North Carolina that the payments under the Replacement and Repair Grants programs for the benefit of low-income homeowners are not includible in the homeowners' gross incomes, and that information

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reporting on such payments is not required with regard to the homeowner beneficiaries but may be required with regard to contractors who perform repair work on the property. Further, we suggest that you advise the State of North Carolina to describe the tax consequences of this assistance to homeowners in language similar to the following:

The Internal Revenue Service has advised us that you need not include in income payments for your benefit in replacing, repairing, or rehabilitating your flood-damaged home, although you may need to include this assistance in income if you previously took a casualty loss deduction for the home being repaired or replaced. See Publication 547, Casualties, Disasters, and Thefts, for more information.

Taxpayers uncertain whether these principles or interpretations of tax law should apply to their situations should consider seeking a private letter ruling or, if appropriate, technical advice. Procedures for issuing letter rulings and technical advice are in Rev. Proc. 2000-1, 2000-1 I.R.B. 4, and Rev. Proc. 2000-2, 2000-1 I.R.B. 73, respectively.

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If you have any further questions about this memorandum, please call George Baker at (202) 622-4920.