



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, DC 20224

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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--
GRANTS TO SMALL BUSINESS ADMINISTRATION (SBA)
LOAN APPLICANTS

This technical assistance memorandum 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.

ISSUE:

Are grants from a State program that assists individuals in repairing their flood-damaged homes by reducing their debt burden includible in the recipients' gross incomes?

CONCLUSION:

The payments, made by the State to reduce debt burdens of individuals repairing their flood-damaged homes, are in the nature of general welfare and are not includible in the recipients' gross incomes. The state should not issue Forms 1099 for the payments because they are not includible in a recipient's income. However, individuals who receive these grants will be required to recognize tax benefit income to account for any deduction based on the losses for which the grants compensate.

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" 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.

Grants to SBA Loan Applicants (2)

This grant program provides payments to individuals who have incurred or will incur additional debt in repairing their flood-damaged homes. The grants are intended to reduce the burden of the additional debt by financially assisting recipients in repairing their homes. The grants range from \$2,500 to \$10,000, depending on the homeowner's age, income, and amount of damage, except that families above a certain adjusted gross family income ceiling are not eligible for grants.

LAW AND ANALYSIS:

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). The Service considered a similar federally funded program in Rev. Rul. 76-395, 1976-2 C.B. 16, and 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). Although the grants to SBA loan applicants are excluded from a recipient's gross income, the grants may, nevertheless, require special tax treatment by the homeowners as described below.

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Individuals who suffered flood damage to their residences and who will receive grants to help defray additional debt incurred for repairing their homes may have been entitled to claim deductions for casualty losses under § 165 of the Code. 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 these grants as reimbursement for the flood losses because the grants are “structured to replace 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 to the extent of the expected reimbursement. In order to correct the error, individuals would be required to amend their returns on which the casualty loss deductions were claimed. If, however, no reasonable prospect of recovering reimbursement existed in the year of the casualty, deductions 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 these grants.

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 grants to SBA loan applicants. If this event, i.e., the receipt of a grant, had occurred in the same taxable year as Hurricane Floyd, the related casualty loss deductions would have been precluded to the extent that the grants reimbursed the losses. Thus, the receipt of grant money is fundamentally inconsistent with the premise of a deduction under § 165, and the tax benefit rule will require a recipient of grant money to include in gross income the amount of the prior year deduction that does not exceed the grant money to the extent the deduction previously reduced tax. Cf. § 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
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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 grants to SBA loan applicants qualify 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 recipients of these otherwise excludable grants will be required to recognize tax benefit income to cancel out any deduction in a prior year based on the losses for which the grants compensate.

Accordingly, we suggest that you advise the State of North Carolina that the grants to SBA loan applicants are not includible in the recipients' gross incomes, and that information reporting is not required on such payments. Further, we suggest that you advise the State of North Carolina to describe the tax consequences of these grants to the recipients in language similar to the following:

Based only on a preliminary description of the program, the Internal Revenue Service has advised us that you need not include in income grants that you, as a successful SBA loan applicant, receive from the State to assist you in repairing your flood-damaged home by reducing your debt burden. You may need to include these grants in income, however, if you previously took a casualty loss deduction for the home being repaired. See Publication 547, Casualties, Disasters, and Thefts, for more information. In addition, the advice that you need not include the grant in income might change if all the facts suggest that the grants promote a purpose other than assisting families in repairing homes damaged from Hurricane Floyd.

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.