

INTERNAL REVENUE SERVICE

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Dear [REDACTED]:

I am writing in response to your letter to former Commissioner Rossotti, dated November 20, 2002, about grant monies received by businesses affected by the September 11, 2001, attacks. You believe these monies should not be subject to federal income tax because taxing such grants is inconsistent with the stated federal goal of encouraging economic recovery in lower Manhattan.

We expect to publish guidance on the income tax treatment of governmental grants to businesses in response to the tragedy of September 11, 2001, in the near future. Meanwhile, I will summarize the established principles of current law on the income tax treatment of governmental grants paid to businesses. Our published guidance 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. Gross income is subject to income tax unless specifically exempted. *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955).

Gross income does not include the value of property acquired by gift (§ 102 of the Internal Revenue Code), or any amount received by an individual as a qualified disaster relief payment (§ 139). In addition, the IRS has concluded 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) promote the general welfare (i.e., be based on need), and
- (iii) not represent compensation for services (Rev. Rul. 82-106, 1982-1 C.B. 16; Rev. Rul. 75-246, 1975-1 C.B. 24).

Governmental grants to businesses generally do not qualify for exclusion from income under the general welfare exclusion because the exclusion relates to payments based on individual need (rather than business 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). Further, governmental grants to businesses in response to a disaster will generally not qualify for exclusion from income as gifts because the government's intent in making the payments comes from its duty to relieve the hardship caused by the disaster, not from detached and disinterested generosity. Also, part of the government's reason in providing the grants is to spur an economic recovery that would increase the government's tax base. See *Kroon v. United States*, Civ. No. A-90-71, 1974 U.S. Dist. LEXIS 8656 (D. Alaska 1974). Finally, governmental grants to businesses do not qualify for exclusion from income as qualified disaster relief payments because that exclusion applies only to payments to individuals (§ 139).

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.

Other provisions of law allow businesses to exclude governmental grants from income, or defer tax on receipt of grant proceeds, 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 (§ 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 the basis of the acquired property by the deferred gain amount (§ 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 (§ 1033(h)(2)). The IRS has consistently applied these principles to governmental grants to businesses, including Community Development Block Grants.

I hope this information is helpful. Please call _____, identification number _____ at _____ if you have any questions.

Sincerely,
 Robert A. Berkovsky
 Branch Chief
 Office of Associate Chief Counsel
 (Income Tax & Accounting)