Memorandum

October 4, 2002

TO: Honorable Carolyn B. Maloney
Attention: Ben Chevat

FROM: Erika Lunder[1]
Law Clerk
American Law Division

SUBJECT: Inclusion of Lower Manhattan Development Corporation grants in gross income

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This memorandum is in response to your letter asking whether the Internal Revenue Service (IRS) can tax the grants made to individuals and businesses by the Lower Manhattan Development Corporation (LMDC). These grants were awarded for a variety of purposes, which could lead to disparate tax treatment for different awards. Some of the grants, e.g., those in the nature of reimbursement for property destruction or rehabilitation expenses, are nontaxable, although businesses may be subject to gain recognition requirements. With respect to grants for other purposes, the IRS could require their inclusion in the recipients' gross income. However, the relevant statutes and case law could also support the opposite determination. Thus, the IRS could find that all of the grants are nontaxable or could distinguish the tax treatment of the grants depending on their purpose.

Characteristics of the Grants

The following information pertaining to the grants administered by the Lower Manhattan Development Corporation (LMDC) was taken from the organization's website.[2] LMDC was created by the State and City of New York to administer grants to help rebuild lower Manhattan after the events of September 11. The U.S. Department of Housing and Urban Development (HUD) funds these grants, and HUD has final approval over each recipient.

LMDC administers two types of grants. First, the Residential Grant Program provides small grants as an incentive for people to live in certain lower Manhattan neighborhoods. Eligibility requires a commitment to live or provide housing in the designated area for a specified time period. Renters and owners, including universities, corporations, and other

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[1] This memorandum was written by Erika Lunder under the supervision of Marie Morris, Legislative Attorney.

[2] http://www.renewnyc.com

institutions, are able to receive funds. The second type of grant involves larger amounts of money for a broader and more complicated set of purposes. According to the grant application[3], grants could be awarded for the following purposes:

1. restoring or rehabilitating conditions in lower Manhattan that were impacted by the events of 9/11,
2. compensating for damage incurred in lower Manhattan by the events of 9/11,
3. building the infrastructure necessary for the revitalization of lower Manhattan,
4. sustaining public and private activities that are necessary for the economic health of lower Manhattan,
5. revitalizing lower Manhattan economically, culturally, physically and/or socially, and
6. facilitating the participation in the planning process by the citizens, communities and victims' families associated with the 9/11 events.

Tax Treatment of Disaster Relief Payments

As a general rule, all income is included in gross income, regardless of its source. 26 U.S.C. 61. Congress can specifically exclude sources of income from gross income by statute, and judicial decisions have excluded other sources. Additionally, positions taken by the IRS through the issuance of revenue rulings have the practical effect of excluding types of income. However, taxpayers may only rely on these rulings when the factual situations are substantially similar. These rulings are not legally binding unless codified in the statutes or adopted by courts.

Here, the actions of the IRS are important because the statutes and regulations were, until last year, silent as to the taxability of disaster relief payments. In the absence of statutory guidance, the limited case law in this area developed through judicial acceptance of the IRS's revenue rulings. The IRS's position has been that certain disaster relief payments are not taxable due to their nature as payments made for the general welfare. Rev. Rul. 76-144, 1976-1 C.B. 17. Since 1957, IRS had determined that a variety of payments that were made in the name of general public welfare were excluded from gross income. *See e.g.*, Rev. Rul. 57-102, 1957-1 C.B. 26 (payments to the blind); Rev. Rul. 75-271, 1975-2 C.B. 23 (mortgage assistance payments), Rev. Rul. 74-205, 1974-1 C.B. 20 (replacement housing payments). Important characteristics of these nontaxable payments included that the payments came from a public fund, were not in the nature of wage or income replacement, were based on financial need, and, in the case of disaster relief, provided limited emergency financial assistance. Rev. Rul. 76-144.

Taxpayers may only rely on revenue rulings to the extent that their factual situations are substantially similar to those in the ruling. While taxpayers and courts may look to such positions for guidance, the IRS is able to modify and revoke the rulings and courts are not required to accept the position or its reasoning. Furthermore, because revenue rulings are heavily dependent on the specific factual situation at issue, the IRS may distinguish prior rulings due to differences in the fact patterns. The IRS's ruling has precedential value only after it has been accepted by the courts or codified in statute. Here, it seems that a general

[3]http://www.renewnyc.org/Content/FundingApReq.pdf

welfare exclusion has been accepted by the courts, including the Supreme Court. *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975), *Bailey v. Commissioner*, 88 T.C. 1293 (1987); *Graff v. Commissioner*, 74 T.C. 743 (1980), aff'd per curiam 673 F.2d 784 (5th Cir. 1982). While this exclusion exists, its scope is not well-defined. Very few cases have dealt with the matter and none has dealt with disaster relief payments.

After the September 11 attacks, Congress added section 139 to the Internal Revenue Code. P.L. 107-134. Section 139 specifically excludes from gross income all qualified disaster payments made to an individual. Section 139(b) defines qualified disaster relief payments as any amount, regardless of source, paid to an individual under these situations:

(1) to reimburse or pay reasonable and necessary personal, family, living, or funeral expenses incurred as a result of a qualified disaster,

(2) to reimburse or pay reasonable and necessary expenses incurred for the repair or rehabilitation of a personal residence or repair of its contents to the extent that the need for such repair, rehabilitation, or replacement is attributable to a qualified disaster,

(3) by a person engaged in the furnishing or sale of transportation as a common carrier by reason of the death or personal physical injuries incurred as a result of a qualified disaster, or

(4) if such amount is paid by a Federal, State, or local government, or agency or instrumentality thereof, in connection with a qualified disaster in order to promote the general welfare.

Any payment for a loss that has been compensated by insurance or other means is included in gross income.

It appears that section 139 is a codification of previous IRS positions and does not make substantive additions to the IRS's definition of what is not taxable. The use of the phrase "to promote the general welfare" in subsection (4) without defining the term suggests an awareness of pre-existing law. Comments accompanying the bill further support the idea that section 139 was intended to coexist with the prior general welfare exception. *Technical Explanation of the "Victims of Terrorism Tax Relief Act of 2001,"* Joint Committee on Taxation; JCX-93-01, pp 15-16.

Issues surrounding the taxability of LMDC Grants

As the above discussion indicates, the purpose of the grant money is examined under both the revenue rulings and the new statute. Since the general rule under section 61 is that all income is included in gross income, the question is whether these grants can be excluded under section 139 or by the general welfare exception found in the case law. This will be discussed in detail below, but the quick answer is that some of the grants are clearly excluded from gross income, but others may or may not be. First, some of the grant money, e.g., that to be used for reimbursement for property loss, is clearly not included in gross income (unless the grant duplicates insurance payments). Grant money for other purposes could be excluded from gross income depending on how broadly the IRS defines "general welfare."

Without guidance from Congress or the courts, it is up to the IRS to determine whether the grants with a range of purposes not focused on traditional disaster relief activities (i.e., compensating for damage not covered by insurance or aiding families with food, clothing, and temporary shelter) are made for the general welfare. Much of the law in this area is based on IRS revenue rulings, which the IRS does not have to follow if it determines the fact patterns are not similar. None of the revenue rulings is directly on point. Thus, the IRS has discretion in whether to tax these non-traditional grants.

Grants to Individuals

With respect to the residential grants, the purpose is to encourage people to live in lower Manhattan. Eligibility is based on a commitment to live in a designated area for a specified time period. These payments do not seem to fulfill the requirements of section 139(b)(1) or (2). Thus, exclusion would have to be based on section 139(b)(4). However, this is not traditionally a payment that promotes the general welfare. In fact, a prior ruling held that payments to encourage residents to remain living in Alaska were included in gross income. Rev. Rul. 76-131, 1976-1 C.B. 16. Furthermore, this grant does not share the characteristics of traditionally excluded payments; for example, it does not compensate for property loss, pay immediate living expenses, or require a showing of financial need.

However, the IRS could find that these payments do promote the general welfare under section 139(b)(4). The payments were made to aid in the rebuilding of a disaster-stricken area, and there is no legal reason why the IRS must have a limited view of section 139(b)(4)'s scope. Instead, there are arguments that support a broad interpretation of the section. The rules of statutory construction assume that Congress does not intend for one clause to merely repeat another. Therefore, section 139(b)(4) must have meaning beyond the traditional relief payments covered under subsections (1) and (2). Furthermore, the payments, while not the type traditionally excluded, are also not the type that clearly must be included in gross income. For example, the payments are not intended to replace lost wages or lost rental income. Thus, there is support on which the IRS could declare the residential payments to be nontaxable.

A similar analysis applies to the other grants given to individuals. Certainly, some of the activities which are open to funding under the LMDC program (e.g., rehabilitation of damaged residential property) are excluded from gross income under section 139(b)(1) and (2). Some of the other activities (e.g., sustaining public and private activities that are necessary for the economic health of the area, revitalizing the area "economically, culturally, physically, and/or socially") are less obvious in their exclusion. Similar to the analysis for the residential grants, the IRS could hold a restricted view of what payments are made to promote the general welfare or could conclude that the grants all fit within the section 139(a)(4) exception. The fact that subsection (4) must serve some purpose and the fact that some of the grant money clearly falls under section 139 might strengthen the argument that the entire group should be considered as payments to "promote the general welfare."

Grants to Businesses

Section 139 only applies to individuals. Thus, grant payments to businesses are subject to the rules before section 139's enactment. Any payments that are meant to reimburse for uninsured property loss should be properly excluded from gross income, but only to extent that the payments do not exceed the adjusted basis of the property. Meanwhile, any payments that are meant to compensate for lost business income should be taxable. However, it does not appear that loss of business income is a criterion for the LMDC grants.

There are several theories under which the IRS could include these grant payments in gross income. First, the limitation of section 139 to payments made to individuals could be interpreted as Congressional intent to prevent the exclusion of similar payments made for business purposes. Second, the IRS could exclude payments based on the argument that these type of payments are outside the scope of the common law's general welfare exception. Similar to the argument for grants made to individuals, the IRS could find that prior law restricted the exception to disaster payments that were need-based or limited to emergency, short-term funding. Third, the IRS could include payments based on the determination that the general welfare exception does not commonly apply to grants to businesses.

However, the IRS has, in rulings heavily dependent on the fact patterns, both allowed and disallowed grants for business purposes to be included in the general welfare exception. *Compare* Rev. Rul. 77-77, 1977-1 C.B. 11 (ruling that payments made under the Indian Financing Act of 1974 to expand Indian-owned businesses were excluded from gross income), *with* Rev. Rul. 80-330, 1980–2 C.B. 29 (ruling that payments made under the National Historic Preservation Act of 1966 to preserve a house used as office space were included in gross income). Thus, the IRS could determine that the grants, so long as they do not compensate for lost business income, should be excluded from gross income.

Can Congress exclude these payments from income?

There is no reason why Congress could not enact a statute that would exclude the grants from taxable income.