**INTERNAL REVENUE SERVICE**

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The Honorable Tom Cole
U.S. House of Representatives
Washington, DC 20515

Dear Mr. Cole:

I am responding to your letter dated January 31, 2005, to Mark Everson, Commissioner of Internal Revenue. You wrote to express deep concern about our June 2004 memorandum that taxpayers who receive mitigation grants to improve property under the Flood Mitigation Assistance Program (FMA), the Pre-Disaster Mitigation Program (PDM), and the Hazard Mitigation Grant Program (HMGP) must include the grants in gross income. You also asked about how the Internal Revenue Service will treat mitigation grant payments made in years prior to 2004.

I assure you that we have thoroughly reviewed our position in the memorandum because of its importance to taxpayers who wish to participate in the mitigation programs. We concluded that our position is consistent with current law, and that the mitigation grants do not qualify for existing statutory or administrative exceptions that would exclude them from income tax.

Under current law, gross income generally includes all income from whatever source derived. Under specific existing statutory and administrative exceptions, gross income excludes certain governmental payments made to individuals in response to need resulting from particular disaster damage that already has occurred. For example, post-disaster relief, such as FEMA grants that help individuals meet necessary expenses or serious needs for medical, dental, housing, personal property, transportation, or funeral expenses is excluded from gross income. The nontaxability of those payments remains unaffected by the June 2004 memorandum. However, grants under the FMA, PDM, and HMGP are made to communities, businesses, and individuals to reduce the risks to hazard-prone properties from future events. For this and other reasons, mitigation grants under these programs generally do not qualify for existing statutory or administrative exceptions.

The Administration shares your concerns, however, and believes that the Internal Revenue Code should be amended to achieve the policy objective of reducing damages from future disasters. In September 2004, then-Treasury Deputy Secretary Bodman wrote to House Ways and Means Committee Chairman William Thomas and Senate Finance Committee Chairman Charles Grassley to urge enactment of appropriate legislation. In addition, the President, in his recent budget recommendations for fiscal year 2006, recommended that the Congress amend the Code to explicitly exclude FEMA mitigation grants from income. *See* Department of the Treasury, General Explanations of the Administration's Fiscal Year 2006 Revenue Proposals, 51-52 (February 2005).

You also wrote that taxpayers who received FEMA mitigation assistance in 2004 may be unaware that such grants would be taxable. As for prior payments, I understand that recognition of the history with respect to particular taxpayers will certainly be taken into account as to whether any enforcement activity by the IRS in this regard is warranted.

I hope this information is helpful. If you have any questions, please contact me at

Sincerely,

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