

Tax Treatment of Grants Made by the Empire State Development Corporation to Businesses to Aid Recovery From the Attack of September 11, 2001, on the World Trade Center

Notice 2003-18

PURPOSE

This notice provides answers to frequently asked questions for businesses not exempt from federal income tax regarding the tax treatment of grant payments the Empire State Development Corporation (the ESDC), in coordination with the New York City Economic Development Corporation (the EDC), will make to businesses under (1) the World Trade Center (WTC) Business Recovery Grant Program, (2) the WTC Small Firm Attraction and Retention Grant Program, and (3) the WTC Job Creation and Retention Program (collectively, the “WTC Grant Programs”).

BACKGROUND

The ESDC is a public benefit corporation of the State of New York and the EDC is a non-profit corporation organized by the City of New York. The ESDC will distribute a portion of \$2.7 billion in Community Development Block Grants (CDBG) appropriated by Congress to enable New York City to make grants under the WTC Grant Programs. In general, the WTC Grant Programs are intended for businesses that were located in the WTC area (the “Eligible Area” as defined in the guidelines for the WTC Grant Programs) or that intend to relocate there, and had or have specified numbers of “full-time permanent employees” (as defined in the guidelines for the WTC Grant Programs). Grant funds under the WTC Grant Programs are also available to tax-exempt non-profit businesses that meet certain additional criteria. The CDBG funds for the WTC Grant Programs were authorized by § 434 of the Departments of Veterans Affairs and Housing and Urban Development and Independent Agencies Appropriations Act, 2002, Pub. L. No. 107-73, 115 Stat. 651, 699 (2001), and Chapter 13 of the Department of Defense and Emergency Supplemental Appropriations for

Recovery from and Response to Terrorist Attacks on the United States Act, 2002, Pub. L. No. 107-117, 115 Stat. 2230, 2336 (2002) (the Acts).

WTC Business Recovery Grant Program

The WTC Business Recovery Grant Program (BRGP) provides grants to compensate certain small businesses that were located in the Eligible Area as of September 11, 2001, for certain losses resulting from the attack on the WTC. The BRGP is administered by ESDC in coordination with EDC on behalf of the State of New York. Grant recipients must continue their business operations at the same location or intend to resume them within New York City. The BRGP is intended to compensate qualified businesses for the net economic losses they incurred from September 11, 2001, through December 31, 2001, in connection with the attack on the WTC. Such net economic losses include, but are not limited to:

- (1) damage to, or destruction of, real property and other tangible assets, including equipment, furniture and fixtures, supplies and inventory;
- (2) financial losses due to business interruption, including reduced business activity;
- (3) employee wages paid for work that was not performed and fees for contract services that were not performed;
- (4) temporary or permanent relocation expenses; and
- (5) debris removal and other clean up costs.

The net economic loss equals the amount of economic loss reduced by other specified governmental grant assistance and by insurance proceeds the business has received or applied for related to its losses.

The amount of a BRGP grant that a business can receive with respect to a particular location equals the lesser of (i) the business’ net economic loss or (ii) the maximum grant amount as computed by the ESDC (which can range from \$50,000 to \$300,000 depending upon the specific area in which the business was located). A business with multiple locations within the Eligible Area may receive a separate grant for each business location. The maximum grant to any business, however, cannot exceed \$500,000. The ESDC may require a grant

recipient to repay BRGP grant funds under certain circumstances.

WTC Small Firm Attraction and Retention Grant Program

The WTC Small Firm Attraction and Retention Grant Program (SFARG) is administered by the ESDC and the EDC on behalf of the City and State of New York. The SFARG program generally is for businesses employing 200 or fewer full-time permanent employees at an eligible premises. The SFARG program provides grants to small businesses that are at risk of leaving downtown Manhattan that commit to remain in the Eligible Area for at least 5 years beyond their current commitment. It also provides grants to small businesses that were located in or near the WTC that commit to remain in New York City for at least 5 years. The SFARG program will also make grants to businesses (for example, new businesses) that commit to remain in the Eligible Area for at least 5 years.

The amount of a SFARG grant generally is \$3,500 per full-time employee. However, a business that was operating in that part of the Eligible Area called the “Restricted Zone” (as defined in the SFARG program guidelines) on September 11, 2001, and remains or relocates within the Eligible Area, is eligible to receive \$5,000 per full-time employee. The grants are generally payable in two installments.

Grant recipients must agree to allocate SFARG funds to wages for full-time permanent employees that were on the business’ payroll as of the dates it requests the grant disbursements. The ESDC may require a grant recipient to repay SFARG funds under certain circumstances, such as relocating a substantial portion of its business from an eligible premises.

WTC Job Creation and Retention Program

The WTC Job Creation and Retention Program (JCRP) includes grants to certain large businesses displaced from their workspace for at least one month as a result of the September 11, 2001, attack on the WTC, and grants to other affected businesses, including those willing to create new jobs in lower Manhattan. This program generally is for businesses employing 200 or more permanent full-time employees. Busi-

nesses receiving JCRP grants must commit to remain in lower Manhattan for a minimum of 7 years and achieve certain employment goals. Although businesses seeking to locate new operations in lower Manhattan are eligible to receive JCRP grants, priority is given to businesses that were located in the Eligible Area on September 11, 2001.

Businesses must use the grant proceeds exclusively for the following expenses incurred after September 11, 2001:

- (1) wages;
- (2) payroll taxes;
- (3) employee benefits;
- (4) rent; and
- (5) moveable equipment and furniture.

The program documents do not indicate that a business must have incurred property losses to receive a JCRP grant or that a JCRP grant is intended to compensate for property losses. The ESDC may require a grant recipient to repay JCRP grant funds if a business does not meet its commitment to retain or create jobs for the minimum 7-year period.

Applicable Provisions of Law

Section 61(a) of the Internal Revenue Code provides that, except as otherwise provided by law, gross income means all income from whatever source derived. Under § 61, Congress intends to tax all gains or undeniable accessions to wealth, clearly realized, over which taxpayers have complete dominion. *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955), 1955-1 C.B. 207.

The Internal Revenue Service has consistently concluded that payments to individuals by governmental units under legislatively provided social benefit programs for the promotion of the general welfare are not includible in a recipient's gross income ("general welfare exclusion"). *See, e.g.*, Rev. Rul. 74-205, 1974-1 C.B. 20; Rev. Rul. 98-19, 1998-1 C.B. 840. To qualify under the general welfare exclusion, payments must: (i) be made from a governmental fund, (ii) be for the promotion of general welfare (*i.e.*, generally based on individual or family needs), and (iii) not represent compensation for services. Rev. Rul. 75-246, 1975-1 C.B. 24; Rev. Rul. 82-106, 1982-1 C.B. 16. Payments to businesses generally do not qualify for the exclusion because they are not based on

individual or family needs. *See Bailey v. Commissioner*, 88 T.C. 1293, 1300-1301 (1987), *acq.*, 1989-2 C.B. 1; Rev. Rul. 76-131, 1976-1 C.B. 16. Moreover, income-replacement payments (whether to businesses or individuals) do not qualify under the general welfare exclusion. *See Rev. Rul. 73-408*, 1973-2 C.B. 15, Rev. Rul. 76-75, 1976-1 C.B. 14, and *Graff v. Commissioner*, 74 T.C. 743 (1980), *aff'd*, 673 F.2d 784 (5th Cir. 1982).

Section 102(a) provides that the value of property acquired by gift is excluded from gross income. Under § 102(a), a gift must proceed "from a 'detached and disinterested generosity,' . . . 'out of affection, respect, admiration, charity or like impulses.'" *Commissioner v. Duberstein*, 363 U.S. 278, 285 (1960), 1960-2 C.B. 428. On the other hand, payments that proceed "primarily from the 'constraining force of any moral or legal duty' or from 'the incentive of anticipated benefit' of an economic nature" are not gifts. *Duberstein* at 285. Governmental grants in response to a disaster (whether to a business or an individual) generally do not qualify as gifts because the government's intent in making the payments proceeds from a government's duty to relieve the hardship caused by the disaster. In addition, a government can expect an economic benefit from programs that relieve business or individual hardships. *See Kroon v. United States*, Civil No. A-90-71 (D. Alaska 1974), and Rev. Rul. 2003-12, 2003-3 I.R.B. 283.

Section 139(a) excludes from gross income any amount received by an individual as a qualified disaster relief payment. Section 139(b)(1) provides, in part, that the term "qualified disaster relief payment" means any amount paid to or for the benefit of an individual:

- (1) to reimburse or pay reasonable and necessary personal, family, living, or funeral expenses incurred as a result of a qualified disaster (§ 139(b)(1));
- (2) to reimburse or pay reasonable and necessary expenses incurred for the repair or rehabilitation of a personal residence, or repair or replacement of its contents, to the extent that the need for such repair, rehabilitation, or replacement is attributable to a qualified disaster (§ 139(b)(2)); or
- (3) 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 (§ 139(b)(4)). Thus, § 139(b)(4) codifies (but does not supplant) the administrative general welfare exclusion with respect to certain disaster relief payments to individuals.

Section 118(a) provides that, in the case of a corporation, gross income does not include any contribution to the capital of the taxpayer. Section 1.118-1 of the Income Tax Regulations provides that § 118 also applies to contributions to capital made by persons other than shareholders. For example, the exclusion applies to the value of land or other property contributed to a corporation by a governmental unit or by a civic group for the purpose of inducing the corporation to locate its business in a particular community, or for the purpose of enabling the corporation to expand its operating facilities. However, the exclusion does not apply to any money or property transferred to the corporation in consideration for goods or services rendered, or to subsidies paid for the purpose of inducing the taxpayer to limit production.

The Supreme Court of the United States has also considered the contribution to capital concept. In *Detroit Edison Co. v. Commissioner*, 319 U.S. 98 (1943), 1943 C.B. 1019, the Court held that payments by prospective customers to an electric utility company to cover the cost of extending the utility's facilities to their homes were part of the price of service rather than contributions to capital. The case concerned customers' payments to a utility company for the estimated cost of constructing service facilities that the utility company otherwise was not obligated to provide.

Later, the Court held that payments to a corporation by community groups to induce the location of a factory in their community represented a contribution to capital. *Brown Shoe Co. v. Commissioner*, 339 U.S. 583 (1950), 1950-1 C.B. 38. The Court concluded that the contributions made by the citizens were made without anticipation of any direct service or recompense, but rather with the expectation that the contributions would prove advantageous to the community at large. *Brown* at 591. The contract entered into by the community groups and the corporation provided that in exchange for a contribution of land and cash, the corporation agreed to construct a fac-

tory, operate it for at least 10 years, and meet a minimum payroll. *Brown* at 586.

Finally, in *United States v. Chicago, B. & Q. R. Co.*, 412 U.S. 401 (1973), 1973-2 C.B. 428, the Court, in determining whether a taxpayer was entitled to depreciate the cost of certain facilities that had been funded by the federal government, held that the governmental subsidies were not contributions to the taxpayer's capital. The Court recognized that the holding in *Detroit Edison Co.* had been qualified by its decision in *Brown Shoe Co.* The Court in *Chicago B. & Q. R. Co.* found that the distinguishing characteristic between those two cases was the differing purposes motivating the respective transfers. In *Brown Shoe Co.*, the only expectation of the contributors was that such contributions might prove advantageous to the community at large. Thus, in *Brown Shoe Co.*, because the transfers were made with the purpose, not of receiving direct service or recompense, but only of obtaining advantage for the general community, the result was a contribution to capital.

The Court in *Chicago, B. & Q. R. Co.*, also stated that there were other characteristics of a nonshareholder contribution to capital implicit in *Detroit Edison Co.* and *Brown Shoe Co.* From these two cases, the Court distilled some of the characteristics of a nonshareholder contribution to capital under both the 1939 and 1954 Codes:

1. It must become a permanent part of the transferee's working capital structure;
2. It may not be compensation, such as a direct payment for a specific, quantifiable service provided for the transferor by the transferee;
3. It must be bargained for;
4. The asset transferred must foreseeably result in benefit to the transferee in an amount commensurate with its value; and
5. The asset ordinarily, if not always, will be employed in or contribute to the production of additional income and its value will be assured in that respect.

Under § 362(c)(2), if money is received by a corporation as a contribution to capital, and is not contributed by a shareholder as such, then the basis of any property acquired with such money during the 12-month period beginning on the day the contribution is received shall be reduced by the amount of such contribution. The excess (if any) of the amount of such contribution over the amount of the reduction

shall be applied to the reduction of the basis of any other property held by the taxpayer.

Section 165(a) allows a deduction for any loss sustained during the taxable year and not compensated for by insurance or otherwise. Section 165(b) limits the amount of the deduction for the loss to the adjusted basis of the property, as determined under § 1011. Under § 165(i)(1), a taxpayer may elect to take a loss attributable to a disaster occurring in a Presidentially declared disaster area into account for the taxable year immediately preceding the taxable year in which the disaster occurred. Section 165(i)(3) provides that the amount of the loss taken into account in the preceding taxable year cannot exceed the uncompensated amount determined on the basis of the facts existing at the date the taxpayer claims the loss. Section 1.165-1(d)(2)(iii) provides that if a taxpayer has deducted a loss and in a subsequent taxable year receives reimbursement for such loss, the amount of the reimbursement must be included in gross income for the taxable year in which received, subject to the provisions of § 111, relating to recovery of amounts previously deducted.

Section 1033(a) provides that if property, as a result of its destruction in whole or in part, is involuntarily converted into money, the gain, if any, is recognized except to the extent that the electing taxpayer, within 2 years after the close of the first taxable year in which any gain was realized, purchases other property similar or related in service or use to the property so converted. Section 1400L(g) extends this replacement period from 2 years to 5 years for property compulsorily or involuntarily converted as a result of the terrorist attacks on September 11, 2001, in the New York Liberty Zone (as defined in § 1400L(h)), if substantially all of the use of the replacement property is in New York City. (The New York Liberty Zone is the area in New York City located on or south of Canal Street, East Broadway (east of its intersection with Canal Street), or Grand Street (east of its intersection with East Broadway)). Under § 1033(a)(2), replacement property is treated as purchased only if, but for the provisions of § 1033(b), its unadjusted basis would be determined under § 1012. In accordance with § 1033(a), the gain is recognized only to the extent that

the amount realized upon such conversion exceeds the cost of the replacement property.

Under § 1033(h)(2), if business or investment property is involuntarily converted due to a Presidentially declared disaster as defined in § 1033(h)(3) (generally, a disaster in an area that has been subsequently determined by the President to warrant federal assistance under the Disaster Relief and Emergency Assistance Act), any tangible property held for productive use in a trade or business is treated as property similar or related in service or use to the converted property.

QUESTIONS AND ANSWERS

Q-1. Are grant payments made under the WTC Grant Programs included in a grant recipient's gross income?

A-1. Generally yes. Payments made under the three WTC grant programs (BRGP, SFARG, and JCRP) are included within the broad definition of "gross income" under § 61 and, as explained in the *Q&As* below, generally do not qualify for any exclusion under the law. A limited exception to this general rule applies in the case of certain JCRP grant payments that qualify for exclusion as a contribution to capital under § 118. *See Q&A-5.*

Grant recipients should note that, even if they must include part or all of a grant in gross income, they are, of course, allowed to deduct against the grant proceeds and other gross income all deductible business expenses, net operating losses, and other allowable deductions (for example, depreciation deductions) for that year. Moreover, to the extent that BRGP grant payments compensate the recipient for damaged or destroyed property, the recipient may offset the amount of the grant payment against the recipient's adjusted basis in the damaged or destroyed property, and defer recognition of the resulting gain under § 1033. *See Q&A-6 and Q&A-7.*

Q-2. Why are payments made under the WTC Grant Programs not excluded from a grant recipient's gross income under the general welfare exclusion?

A-2. The grant payments under the WTC Grant Programs do not qualify for the general welfare exclusion because that exclusion generally is limited to individuals who receive governmental payments to help them with their individual needs (*e.g.*, housing, education, and basic sustenance ex-

penses). In addition, grant payments that compensate for lost profits or business income (whether to individuals or to businesses) do not qualify for the general welfare exclusion.

Q-3. Why are grant payments made under the WTC Grant Programs not excluded from a grant recipient's gross income as gifts under § 102?

A-3. The governmental grant payments to businesses under the WTC Grant Programs do not qualify for the gift exclusion under § 102(a) because the intent of the federal, state, and local governments in making these payments proceeds, not from charity or detached and disinterested generosity, but from the government's duty to relieve the hardship resulting from the disaster and the economic benefits it anticipates from a revitalized New York City economy. *See Kroon*. Neither the Acts that appropriated the CDBG funds for the WTC Grant Programs nor the legislative history of those Acts disclose a donative intent. Instead, Congress indicated that the grant funds were for "economic revitalization," to help New York City in its "overall economic recovery," and to assist the "economic recovery" of areas affected by the terrorist attack. *See* § 434 of Pub. L. No. 107-73, H.R. Conf. Rep. No. 272, 107th Cong. 1st Sess. 176 (2001), and H.R. Conf. Rep. No. 350, 107th Cong. 1st Sess. 455 (2001).

Q-4. Why are grant payments made under the WTC Grant Programs not excluded from a grant recipient's gross income as qualified disaster relief payments under § 139?

A-4. The grant payments under the WTC Grant Programs to businesses other than sole proprietors do not qualify for exclusion from gross income under § 139 because that exclusion applies only to individuals. In the case of sole proprietors, the grant payments made under the WTC Grant Programs do not qualify for exclusion under § 139 because the payments are not made for any of the specific purposes described in § 139(b)(1), (2), or (4).

Q-5. Are payments made under the WTC Grant Programs excluded from gross income as contributions to capital under § 118?

A-5. No, in the case of BRGP and SFARG grant payments, but yes in the case of some JCRP payments.

The BRGP grant payments compensate small businesses for certain losses resulting from the September 11, 2001, attacks on the WTC. Accordingly, these payments are more akin to insurance payments received for losses than contributions to capital of a corporation, within the definition of § 118 and the case law.

Businesses must use SFARG grant payments to pay wages of their employees, an ordinary business expense under § 162. Accordingly, such payments are not contributions to the capital of the recipient corporation under § 118 and the case law. The BRGP and SFARG grant payments must be included in gross income under § 61. *See Q&A-1*.

To the extent a corporate recipient of a JCRP grant payment applies for, receives, and utilizes the grant funds to acquire furniture and equipment, the JCRP grant payment will be a nonshareholder contribution to capital under § 118 and the case law. Pursuant to § 362(c), the basis of furniture and equipment acquired will be reduced by the amount of the JCRP grant received for such purposes.

JCRP grant payments that are made for the other listed purposes of wages, payroll taxes, employee benefits, and rent are not contributions to the capital of a corporation under § 118 and the case law. These payments must be included in gross income under § 61. *See Q&A-1*.

Q-6. Must recipients of grant payments made under the WTC Grant Programs reduce the amount of an allowable casualty loss deduction under § 165 or include in gross income all or part of a casualty loss claimed in a prior year?

A-6. No, in the case of SFARG and JCRP grant payments, but yes in the case of BRGP grant payments.

Section 165 allows deductions for certain losses sustained during the taxable year only if the loss is not compensated by insurance or otherwise. SFARG and JCRP grant payments are not treated as payments in the nature of insurance compensation under § 165 because they are not paid to compensate the business for losses to damaged or destroyed property. Thus, SFARG and JCRP grant payments do not reduce losses on any property destroyed or damaged in the attack on the WTC. SFARG and JCRP grant payments must be included in gross income (*see Q&A-1*) except to the extent

that JCRP payments qualify as an excludable contribution to capital under § 118. *See Q&A-5*.

One purpose of the BRGP is to compensate businesses for damage to, or destruction of, real property and other tangible assets, including equipment, furniture and fixtures, supplies, and inventory. Thus, BRGP payments are treated as compensation received for such losses under § 165 to the extent they compensate businesses for their property losses. If a business properly deducted property losses resulting from the WTC attack on a federal income tax return (for example, for 2000 or 2001), and is reimbursed for that loss by a BRGP grant payment in a later year, the business must include the amount of reimbursement in gross income, as ordinary income, on its federal income tax return for that later year to the extent that its income tax liability for the prior year was reduced by reason of the prior year property loss deduction. *See* § 165(i)(1) and § 1.165-1(d)(2)(iii). A business that did not deduct the property loss on a return for a year prior to the year in which it received the grant payment must reduce any allowable deduction for property loss by the amount of the BRGP grant payment to the extent such payment compensates for that property loss. If the amount of compensation exceeds the business' basis in the damaged or destroyed property, the excess (gain) generally must be included in gross income unless the business qualifies to defer recognition of the gain under § 1033. *See Q&A-7*.

Q-7. May a business defer, under § 1033, recognition of gain realized on receipt of a grant payment made under the WTC Grant Programs?

A-7. Yes, in the case of BRGP grant payments (SFARG and JCRP grant payments are not paid to compensate the business for losses to damaged or destroyed property). A business may elect, under § 1033, to defer the gain on BRGP grant payments received to compensate for losses due to damage to, or destruction of, real property and other tangible assets, including equipment, furniture and fixtures, supplies, and inventory used in a trade or business caused by the attack on the WTC.

Businesses using BRGP grant payments for the purpose of repairing or replacing the damaged or destroyed property generally are eligible to defer gain under § 1033, if they make the required election and timely pur-

chase property similar or related in service or use to the converted property, the basis of which would be determined under § 1012 if § 1033(b) did not apply (“qualified replacement property”). Amounts paid by the grant recipients to repair damaged or destroyed property, including amounts paid for debris removal and other clean-up costs, are generally treated as amounts paid to purchase qualified replacement property. In addition, because the property for which businesses will receive the BRGP grant payments was destroyed in a Presidentially declared disaster, the businesses may use the BRGP grant payments to purchase any tangible property of a type held for use in a trade or business and still defer recognition of the gain. *See* § 1033(h)(2). A BRGP grant recipient must replace the damaged or destroyed property within 2 years after the close of the taxable year in which the BRGP grant payment is received (or 5 years if the property was damaged or destroyed due to the September 11, 2001, terrorist attacks in the New York Liberty Zone and substantially all of the use of the replacement property is in New York City), but if necessary may request additional time from its local IRS office. The basis of the new property usually will be the same as the basis of the old property if the entire amount of compensation for the damaged property is used to purchase the replacement property.

The following example illustrates the application of §§ 165 and 1033 to a business receiving a BRGP grant payment.

Example. (i) Business *X* owned tangible personal property with a fair market value of \$18,000 and a basis of \$10,000 that was destroyed in the attack on the World Trade Center. *X* filed an amended 2000 federal income tax return and properly claimed a casualty loss of \$10,000. In 2003, *X* receives a BRGP grant payment of \$18,000 as a result of damage to its tangible personal property and uses the entire amount to purchase replacement property for use in its trade or business.

(ii) Pursuant to § 111 and the tax benefit rule, *X* must include in gross income on its 2003 federal income tax return \$10,000 of the grant as ordinary income, attributable to the property loss deduction *X* took on its 2000 income tax return. *X* may defer including in income the remaining \$8,000 of the grant under § 1033, assuming the requirements of that section are met. *X*'s basis in the replacement property is \$10,000 (\$18,000 cost of the replacement property minus \$8,000 gain deferred under § 1033).

The principal author of this notice is Shareen S. Pflanz of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this notice, contact Mrs. Shareen Pflanz at 202-622-4920 (not a toll-free call).