Part I

Section 61.–Gross income defined

26 CFR 1.61-1(a): Gross income
(Also: §§ 102, 118, 139, 165, 1033; 1.102-1, 1.118-1, 1.165-1, 1.1033(a)-1.)

Rev. Rul. 2005-46

ISSUES:

(1) Is a grant that a qualifying business receives under a state's program to reimburse losses that any qualifying business incurred for damage or destruction of real and personal property on account of a disaster excludable from gross income --

(a) under the general welfare exclusion;

(b) as a gift under § 102 of the Internal Revenue Code;

(c) as a qualified disaster relief payment under § 139; or

(d) as a contribution to the capital of a corporation under § 118?

(2) May a qualifying business defer, under § 1033, recognition of gain realized on receipt of a grant payment made under the state program?

FACTS

An area within state *ST* was affected by a disaster. To aid in the recovery of the area of *ST* affected by the disaster, *ST* enacted emergency legislation appropriating funds for grants to reimburse uncompensated losses that any qualifying business incurred due to damage to, or destruction of, real property and other tangible assets, including buildings, structures, fixtures, equipment, and inventory (collectively, the "eligible losses") on account of the disaster.

The grants are available only if the qualifying business agrees to continue its operations for a minimum of 5 years in or near the area in *ST* affected by the disaster. Reimbursement of eligible losses is limited to the fair market value of the property just before the time of the loss and is reduced by any other reimbursement that the qualifying business received to compensate for the property losses. A qualifying business must submit an application to *ST* describing the nature, extent, and amount of the uncompensated eligible losses that the qualifying business incurred.

As a result of the disaster, *X*, a corporation, incurred $90,000 of uncompensated eligible losses for destruction of equipment used by *X* in its trade or business. The adjusted basis of the equipment was $10,000. *X* did not deduct the $10,000 loss for the destruction of the equipment on any federal income tax return. *X* submitted an application to *ST* for a grant to reimburse *X* for the uncompensated eligible losses. During *X*'s subsequent taxable year, *ST* officials approved a $90,000 grant based on the destruction of *X*'s property and paid the $90,000 to *X*.

Within the 2-year period prescribed by § 1033(a), *X* purchased for $150,000 (by using the entire grant proceeds of $90,000 plus $60,000 of other funds) equipment to

replace the destroyed equipment. The replacement equipment was similar or related in service or in use to the destroyed equipment. *X* has used the replacement equipment in its trade or business since the time of the purchase. *X* elected under § 1033(a)(2)(A) to defer gain realized on the involuntary conversion of its equipment into money.

LAW AND ANALYSIS

Section 61(a) 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 included 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 the 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 under the general welfare exclusion because the payments 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; Notice 2003-18, 2003-1 C.B. 699.

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, 2003-1 C.B. 283.

Section 139(a) excludes from gross income any amount received by an individual as a qualified disaster relief payment. Section 139(b) 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 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 Shoe Co.* 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 factory, operate it for at least 10 years, and meet a minimum payroll. *Brown Shoe Co.* 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 a 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. 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 (or at the close of such later date as may be designated pursuant to an application of the taxpayer under § 1033(a)(2)(B)(ii)), purchases other property similar or related in service or use to the property so converted ("qualified replacement property"). Under § 1033(a)(2), qualified 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 qualified replacement property.

Under § 61, *X* must include in gross income *ST*'s $90,000 grant payment unless another provision of the Code excludes it from income or defers recognition of the income.

X may not exclude *ST*'s $90,000 grant payment from gross income under the general welfare exclusion, because that exclusion is limited to individuals who receive governmental payments to help with their individual needs (*e.g.*, housing, education, and basic sustenance expenses).

X may not exclude the grant payment from gross income under § 102 because *ST*'s intent in making the grant payments proceeds, not from charity or detached or 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 economy in the area of *ST* affected by the disaster. *See Kroon*. *ST* did not enact the legislation authorizing the grant program for any donative purpose.

X may not exclude the grant payment from gross income under § 139 because that exclusion applies only to individuals. Even if *X*'s business were a sole proprietorship or the disaster were a qualified disaster under § 139, the grant payments would not qualify for exclusion from gross income under § 139 because the grant payments are not made for any of the specific purposes described in § 139(b)(1), (2), and (4).

X may not exclude the $90,000 grant payment from gross income under § 118. The *ST* grant program compensates qualifying businesses for uncompensated eligible losses they incurred as a result of the disaster. 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. Because the $90,000 grant

payment is not excludable from gross income under § 118, the basis of the replacement equipment purchased by *X* is not determined under § 362(c)(2).

Under § 61, *X* realizes gain of $80,000 ($90,000 grant proceeds received less $10,000 adjusted basis in the destroyed equipment). *X* must recognize the $80,000 gain unless *X* elects to defer recognition of the gain under § 1033.

X may defer including in income the entire $80,000 gain because *X* meets all of the requirements to defer the gain under § 1033. First, the grant payments are compensation for the involuntarily converted property. Second, *X* made the required election under § 1033 and, within 2 years after the close of the taxable year in which *X* received the *ST* grant payment, replaced the destroyed equipment with qualified replacement property, the basis of which would be determined under § 1012 if § 1033(b) did not apply. Third, the cost of the qualified replacement property ($150,000) exceeds the gain realized on the conversion of the destroyed equipment into money ($80,000). Amounts paid by *X* 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.

X's basis in the replacement equipment is $70,000 ($150,000 cost of qualified replacement property less $80,000 unrecognized gain on the conversion of the destroyed equipment into money). *See* § 1033(b)(2).

The *ST* grant program reimburses uncompensated eligible losses incurred by any qualifying business. Therefore, the grant payments are treated as compensation received for such losses under § 165. If *X* had properly deducted the $10,000 adjusted

basis of the equipment as a loss on a prior year federal income tax return, and the loss reduced the amount of *X*'s tax in that year, then *X* would be required by § 111 and the tax benefit rule to include $10,000 of the $90,000 gain realized from the receipt of the *ST* grant in gross income, as ordinary income, on its federal income tax return for the year it received the grant. *See* § 1.165-1(d)(2)(iii). Under § 1033, *X* could defer including in income the remaining $80,000 of gain ($90,000 grant less $0 adjusted basis in the converted property less $10,000 recovery of the prior year deduction). In addition, *X*'s basis in the replacement equipment would equal $70,000 (excess of $150,000 cost of replacement property over $80,000 gain not recognized).

HOLDINGS

Under the facts of this ruling:

(1) A grant that a qualifying business receives under a state's program to reimburse losses that any qualifying business incurred for damage or destruction of real and personal property on account of a disaster is not excludable from gross income --

(a) under the general welfare exclusion;

(b) as a gift under § 102;

(c) as a qualified disaster relief payment under § 139; or

(d) as a contribution to the capital of a corporation under § 118.

(2) A qualifying business that receives a grant payment under the state's program to reimburse losses that the qualifying business incurred for damage or destruction of real and personal property may elect to defer including in income gain realized from receipt of the grant under § 1033 to the extent the grant proceeds (or

other funds in lieu of the grant proceeds) are used to timely purchase property similar or related in service or use to the destroyed or damaged property.

DRAFTING INFORMATION

The principal author of this revenue ruling is Sheldon A. Iskow of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue ruling, contact Mr. Iskow on (202) 622-4920 (not a toll-free call).