



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, DC 20224
June 30, 2000

OFFICE OF
CHIEF COUNSEL

CC:DOM:IT&A:2
WTA-N-100541-00

Number: **200032041**
Release Date: 8/11/2000

UILC: 61.11-03
6041.03-00

MEMORANDUM FOR HARRY MARTIN
FED-STATE COORDINATOR, NORTH-SOUTH CAROLINA
DISTRICT

FROM: Lewis J. Fernandez (by George Baker)
Deputy Assistant Chief Counsel
(Income Tax & Accounting)

SUBJECT: NORTH CAROLINA FLOOD RELIEF - PROPERTY LOSS
PAYMENTS

This Technical Assistance is in response to your request for assistance dated December 15, 1999, regarding the tax treatment of state payments made to individuals and businesses of North Carolina who suffered losses due to the flood damage caused by Hurricane Floyd. Technical Assistance does not relate to a specific case and is not binding on examination or appeals. This document is not to be cited as precedent.

ISSUE:

Are the following flood relief payments gross income to the recipient upon which information reporting is required under § 6041 of the Internal Revenue Code: payments to farmers and commercial fishermen for structure and equipment losses and supplemental payments to farmers to assist in restoring farmlands to usable areas and to restore the use of best management practices?

CONCLUSION:

The flood relief payments to the recipients are generally includible in gross income except to the extent an exclusion or nonrecognition provision applies. However, information reporting is not required under § 6041 for payments to farmers and commercial fishermen for structure and equipment losses and supplemental payments to farmers to assist in restoring farmlands to usable areas and to restore the use of best management practices.

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FACTS:

The General Assembly of North Carolina declared Hurricane Floyd the worst natural disaster in the State's history. In the latter part of 1999, Hurricane Floyd caused extensive and prolonged flooding that devastated the civil, social, economic and environmental well-being of Eastern North Carolina. The entire economic base of Eastern North Carolina was undermined making it extremely difficult for individuals to earn an income to support themselves and their families. In response to the widespread damage caused by Hurricane Floyd, Governor Jim Hunt, Jr. of North Carolina proposed a state emergency package that consisted of numerous relief programs to assist individuals and small businesses in recovering from the disaster. The "Hurricane Floyd Recovery Act of 1999," appropriating funds for a package of relief programs, was enacted on December 16, 1999.

The following disaster assistance programs are addressed in this Technical Assistance. The numbers appeared in the margin of materials in your request for assistance.

Farm Structure Disaster Assistance (9)

This grant program provides partial payment to farmers to compensate them for structure and equipment losses caused by Hurricane Floyd. Under this program, farmers must report structure losses and have them verified by State officials.

Emergency Conservation Program Cost Share Buy-Down (10)

The Emergency Conservation Program ("ECP") provides payments to farmers to assist with their portion of cost share for restoration of farmlands to usable areas and for restoration of best management practices ("BMPs"). The ECP includes: removing debris from farmland; grading and shaping of farmland or similar measures; fence restoration; and restoring structures and other installations.

Through the North Carolina Agriculture Cost Share Program, Soil and Water Conservation Districts had installed over 14,000 agricultural BMPs in the counties affected by Hurricane Floyd. The BMPs that were damaged by Hurricane Floyd may include: animal waste management structures or components of waste management systems (e.g., pumps), livestock exclusion fencing, remote watering devices for livestock, riparian buffers, terraces, grassed waterways, stream crossings and water control structures. These BMPs will have to be repaired within the next two years to prevent extensive harm to water quality in Eastern North Carolina.

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Commercial Fishing Disaster Assistance (12)

This fishing loss disaster assistance program provides North Carolina fishermen with grants and loans to compensate them for loss of gear caused by the flooding. At this time, we do not discuss the treatment of loans under this program as we lack sufficient information regarding terms and collateral to express an opinion.

LAW AND ANALYSIS:

State Grants

Section 61(a) provides generally that gross income means all income from whatever source derived. Section 1.61-1(a) of the Income Tax Regulations provides that gross income includes income realized in any form. In Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955), 1955-1 C.B. 207, the United States Supreme Court held that the concept of gross income encompassed accessions to wealth, clearly realized, over which taxpayers have complete dominion.

Section 1001(a) provides generally that gain or loss from the sale or other disposition of property is measured by the difference between the amount realized on the disposition and the property's adjusted basis. Section 1001(c) provides that the entire gain or loss shall be recognized except as otherwise provided.

One exception to § 1001(c) is § 1033. It provides, in part, that if property, as a result of its destruction in whole or in part, is involuntarily converted into money or into property not similar or related in service or use to the converted property, the gain, if any, shall be recognized except to the extent that the electing taxpayer, within two 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. In that event, the gain shall be recognized only to the extent that the amount realized upon such conversion (regardless of whether such amount is received in one or more taxable years) exceeds the cost of such other property.

Section 1033(b)(2) provides that if property is converted into money, and the taxpayer purchases qualified replacement property and elects nonrecognition of gain under § 1033(a)(2), then the basis of the replacement property shall be the cost of such property decreased by the amount of gain not recognized.

The grants for property repair or replacement fall within the § 61(a) and Glenshaw Glass definition of income and generally are includible in income, except to the extent an exclusion or nonrecognition provision applies.

The general goal of the "Hurricane Floyd Recovery Act of 1999," is to aid recovery to individuals that suffered losses as a result of flood damage. Thus, it is appropriate to

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consider grants provided for property damage or loss as received on account of the hurricane damage and to allow taxpayers to elect § 1033 treatment to the extent that the taxpayer incurs costs to remediate the damage caused by the hurricane. Grants received in excess of the damage or loss to the property are income to the recipient under § 61(a) and Glenshaw Glass.

Property Loss

Individuals who suffered property loss or damage as a result of Hurricane Floyd may have been entitled to claim deductions for casualty losses under § 165 of the Code. Section 165 permits a deduction for “any loss sustained during the taxable year and not compensated for by insurance or otherwise.” Section 1.165-1(d)(2)(i) of the Income Tax Regulations provides that no portion of a loss is “sustained” for purposes of a deduction under § 165 if there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery. We view these grants as reimbursement for the flood losses because the grants are “structured to replace what was lost.” Estate of Bryan v. Comm’r, 74 T.C. 725 (1980); Rev. Rul. 87-117, 1987-2 C.B. 61.

If a reasonable prospect of recovering reimbursement existed in the year of the flood, deductions claimed for casualty losses were erroneous to the extent of the expected reimbursement. In order to correct the error, individuals would be required to amend the returns on which the casualty loss deductions were claimed. If, however, no reasonable prospect of recovering reimbursement existed in the year of the flood, deductions for casualty losses were proper. The tax benefit rule, however, might require individuals who properly claimed deductions to include all or a portion of the amount of their deductions in gross income when they later receive these grants.

The tax benefit rule ordinarily requires taxpayers to include in gross income the amount of a prior year deduction when an event occurs that is fundamentally inconsistent with the premise of the deduction. See Hillsboro Nat’l Bank v. Comm’r, 460 U.S. 370 (1983). An event is fundamentally inconsistent with the premise of a deduction if the deduction would have been precluded had the event occurred in the same taxable year as the deduction. Id. Here, the event to be considered in reference to the casualty loss deductions is the receipt of grants to individuals who suffered property loss or damage. If this event, i.e., the receipt of a grant, had occurred in the same taxable year as Hurricane Floyd, casualty loss deductions would have been precluded to the extent that the grants reimbursed the losses. Thus, the receipt of grant money is fundamentally inconsistent with the premise of a deduction under § 165, and the tax benefit rule will require a recipient of grant money to include in gross income the amount of the prior year deduction that does not exceed the grant money to the extent the deduction previously reduced tax. See § 111, Recovery of Tax Benefit items. Section 1.165-1(d)(2)(iii) supports this conclusion, providing that a taxpayer who has deducted a loss and in a subsequent year receives reimbursement for the loss must include the

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reimbursement in gross income for the taxable year in which received, subject to the provisions of § 111.

When an event that is fundamentally inconsistent with the premise of a deduction occurs in the context of a nonrecognition provision, we must resolve the inherent tension between the nonrecognition provision and the inclusion required by the tax benefit rule. Hillsboro, 460 U.S. 370. Even though the grants qualify for nonrecognition under § 1033, we conclude that any inclusion required by the tax benefit rule will override the rule of nonrecognition. See Rev. Rul. 74-206, 1974-1 C.B. 198.

Soil and Water Conservation Expenditures

Section 175 provides generally that a taxpayer engaged in the business of farming may treat expenditures which are paid or incurred by him during the taxable year for the purpose of soil or water conservation in respect of land used in farming, or for the prevention of erosion of land used in farming, as expenses which are not chargeable to capital account. The expenditures so treated shall be allowed as a deduction. Under § 175, a farmer may deduct soil or water conservation expenditures which do not give rise to a deduction and which are not otherwise deductible. See §1.175-1. The amount of the deduction is limited annually to 25 percent of the taxpayer's gross income from farming. Any excess may be carried over and deducted in succeeding taxable years. See § 175(b). As a general rule, once a farmer has adopted this method of treating soil and water conservation expenditures, that farmer must deduct all such expenditures (subject to the 25-percent limitation) for the current and subsequent taxable years. See § 1.175-6. If a farmer does not adopt this method, such expenditures increase the basis of the property to which they relate.

Information Reporting

Section 6041(a) provides that all persons engaged in a trade or business and making payment in the course of such trade or business to another person of rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments or other fixed or determinable gains, profits, and income of \$600 or more in any taxable year shall render a true and accurate return to the Secretary of the Treasury, under such regulations and in such form and manner and to such extent as may be prescribed, setting forth the amount of such gains, profits and income, and the name and address of the recipient of such payment. Under § 1.6041-1(b), federal and state governments are considered persons engaged in a trade or business for purposes of § 6041.

As used in § 6041, the term "gains, profits and income" means gross income and not the gross amount paid. A payor is not required to make a return under § 6041 for payments that are not includible in the recipient's income, nor is a payor required to make a return if the payor does not have a basis to determine the amount of the

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payment that is required to be included in the recipient's gross income. See Rev. Rul. 80-22, 1980-1 C.B. 286, amplified by Rev. Rul. 82-93, 1982-1 C.B. 196.

When North Carolina pays a grant to a taxpayer for property loss or repair, it cannot identify the amount of the payment considered "gains, profit or income" to the payee. The State cannot determine a payee's adjusted basis in damaged property or the amount of the payment a property owner used to repair or replace the property. Additionally, the State does not know whether a payee elected to defer gain under § 1033. Therefore, because the payee's "gains, profits or income," are not fixed or determinable under § 6041, the State is not required to issue Form 1099 information returns with respect to grants for damaged or lost property.

We suggest that you advise the State of North Carolina to describe the tax consequences of these grants to the recipients in language similar to the following:

The Internal Revenue Service has advised us that taxpayers are required to include in income grants received on account of farm equipment and structure loss, and commercial fishing gear loss caused by Hurricane Floyd, except to the extent nonrecognition under § 1033 is elected. Even if § 1033 is elected, the grants are included in income if a taxpayer has properly claimed a deduction for property loss in a prior year and received a grant compensating the taxpayer for the loss in a later year. Taxpayers also may be entitled to a deduction for soil and water conservation expenditures under § 175. Information may also be found in IRS Publication 225, Farmer's Tax Guide.

Taxpayers uncertain whether these principles or interpretations of tax law should apply to their situations should consider seeking a private letter ruling or, if appropriate, technical advice. Procedures for issuing letter rulings and technical advice are in Rev. Proc. 2000-1, 2000-1 I.R.B. 4, and Rev. Proc. 2000-2, 2000-1 I.R.B. 73, respectively.

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If you have further questions about this memorandum, please call George Baker at (202) 622-4920.