DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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OFFICE OF
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MEMORANDUM FOR [redacted], GROUP MANAGER 1436
NORTH CENTRAL DISTRICT

FROM: Acting Assistant Chief Counsel
(Income Tax & Accounting)
Heather Maloy by George Baker

SUBJECT: City of Grand Forks, ND, Downtown Commercial Rehabilitation Program

This technical assistance responds to your memorandum dated March 25, 1998. You requested our views on the tax treatment of the Downtown Commercial Rehabilitation Program of the City of Grand Forks, ND. 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.

ISSUES:

(1) Is § 1033 (pertaining to deferral of gain recognition in the event of an involuntary conversion) available to a taxpayer receiving a Program grant?

(2) Must a taxpayer receiving a Program grant take that grant into account in determining the availability of a loss deduction under § 165?

(3) Are the costs of the street level and facade improvements constructed with Program funds deductible by taxpayers under § 162, or must those costs be capitalized under § 263?

(4) Are the costs of applying for a grant (other than those costs that are also related to constructing the improvements) currently deductible under § 162?

(5) What basis do taxpayers take in the street level and facade improvements?

(6) What information reporting requirements, if any, does the City have with respect to the Program funds paid to grant recipients?

CONCLUSIONS:

(1) Although urban revitalization grants to pay for improvements to a taxpayer's property are, in general, gross income to the recipient taxpayers under § 61(a), a grant recipient may treat the Program funds as received on account of the flood damage and elect, in accordance with § 1033, to defer recognition of gain to the extent the taxpayer incurs costs to remediate the flood damage to the property.

(2) Only those Program funds that are received on account of the flood damage must be taken into account in determining whether a loss deduction is available to the taxpayer under § 165. If, in a prior taxable year, the taxpayer properly took a casualty loss deduction for the flood damage, Program funds received on account of flood damage are considered a recovery of an amount previously deducted under § 165 and must be included in the taxpayer's income in the taxable year received to the extent required by tax benefit principles.

(3) The costs of constructing street level and facade improvements must generally be capitalized under § 263.

(4) Whether costs of applying for a grant (other than those costs that are allocable to constructing the improvements) are deductible under § 162 or must be capitalized may vary from taxpayer to taxpayer depending on the timing of the taxpayer's expenditures and its receipt of the grant proceeds. We will be happy to provide further assistance if you need it in any specific case.

(5) A taxpayer will take a § 1012 cost basis in the street level and facade improvements except to the extent the taxpayer has elected § 1033 treatment for Program funds. If the taxpayer elects § 1033 treatment for Program funds expended to remediate flood damage to the property, the basis of the property will be determined under § 1033(b)(2).

(6) The City is not required to file information returns under § 6041 to report grants under the Program.

FACTS:

The City of Grand Forks, ND (City) suffered extensive flood and fire damage in April 1997. The area encompassing the City subsequently was declared a Presidential disaster area and the City became eligible to receive federal funding provided to deal with the disaster. Public Law 105-18, 111 Stat. 158, 198-9, appropriated to the United States Department of Housing and Urban Development an additional amount ("for Community development block grants fund") "for use only for buyouts, relocation, long-term recovery, and mitigation in communities affected by the flooding in the upper Midwest and other disasters in fiscal year 1997... ."

The City received funds under this appropriation to assist in its recovery from the flood. Using some of these funds, the City, in November 1997, established a grant program, known as the Downtown Commercial Rehabilitation Program (Program) through its Office of Urban Development (Office). The Program targeted businesses in the core downtown commercial area of Grand Forks. Prior to the April 1997 disaster, the targeted area was blighted and economically depressed. That same area suffered the most severe damage from the flood and fire. The materials submitted indicated that every property eligible for the Program was damaged in the flood or fire.

The Program's stated purpose is the improvement of the exterior facades and street level interiors of commercial buildings and the revitalization of businesses and property. The grants are provided in recognition of the significant impact that improvements to storefronts and street level interior space will have on the appearance and marketability of the core downtown commercial area in Grand Forks.

The Program has three goals:

(i) To help downtown business activity recover from the flood and to enhance downtown's economic viability and the City's tax base, by restoring an attractive commercial environment to the street level of buildings in the downtown commercial core;

(ii) To promote increased employment activities, a stronger retail environment in the downtown, and increased retail services and activities for the downtown business community and City residents by providing incentives for the retention, expansion, and relocation of businesses within the downtown; and

(iii) To stimulate private investment that otherwise would not have occurred in downtown Grand Forks by providing a public funding program as an initial investment catalyst.

It is the intent of the Program to encourage and assist businesses that will restore an active pedestrian environment and a vibrant retail base to downtown. The Program targets three types of businesses expected to meet this intent. These are (1) small specialty goods retailers and restaurants, (2) retail office businesses, and (3)

nontransactional establishments.[1] The first category of business is eligible to receive up to $50 per square foot of street level space; the second category, up to $20 per square foot of street level space; and the third category, up to $10 per square foot of street level space.

Eligible interior space improvements include permanent tenant improvements within active retail space, structural improvements to the building, and modernization of building systems such as HVAC and code upgrades. Necessary or mandated required improvements such as kitchens, public rest rooms, and Americans with Disabilities Act requirements are also eligible costs. Inventory, back office, warehousing, distribution, and all other non-active retail space are not eligible for grant funds.

Facade improvements include signs, awnings, exterior painting, repair/replacement of existing storefront elements, exterior lighting, interior window display design and artistic murals. Upper floor improvements are not eligible, and will not be considered, except where they are structurally necessary in the context of overall improvements or where ground floor appearances will be significantly enhanced by the improvements.

The Office will administer the grants. The Program will provide grants to building owners to improve street level commercial space, and up to $10,000 per grantee to improve building facades, with a maximum grant of $250,000 per applicant. The most important criteria for granting funds are that the grantee's building be located in the specified target area and have a qualifying street level and/or facade upgrading project. Location, historic importance, blighted appearance, and other targeted needs are given special consideration and high priority in determining grant recipients. The City encourages clustering of applications by adjacent building owners to maximize the impact of streetscape improvements.

In each category of business, the grantee is required to provide 15 percent in matching funds. Smaller grant awards will be disbursed once the construction has been completed and the City has inspected the improvements. Larger grants may be disbursed in phases upon receipt of invoices.

Although the repair of flood- and fire-caused damages is not the primary purpose of the Program, such repairs are necessary to carry out the stated purpose of the Program. Further, the appropriation funding the Program was intended to aid in the recovery from the flood, among other purposes. To avoid double benefits, however, the Program documents state that –

> [G]rant monies will not be used to fund repairs that have already been funded by flood insurance payments or SBA

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[1] The nontransactional establishments include contractors' offices, offices for social service groups, civic organizations, informational offices, foundations, educational organizations, job training, consulting or other research organizations, and union offices.

> loans. Grant monies can be used to do improvements above and beyond those covered by SBA and flood insurance as well as meet new code requirements or to fund physical improvements not covered by these other sources of federal assistance.

Your memorandum also asked us to consider whether our conclusions depend on whether a grant recipient does business as a partnership or a sole proprietorship. The conclusions apply to either type of taxpayer.

LAW AND ANALYSIS:

Discussion of Issue (1)

Section 61(a) provides generally that gross income means all income from whatever source derived. 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. The Program grants clearly fall within the § 61(a) and Glenshaw Glass definition of income,[2] and generally are includible in the recipients' gross income at the time appropriate under their methods of accounting, except to the extent an exclusion or nonrecognition provision applies.

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, which allows for the current nonrecognition (and deferral) of gain when property is compulsorily or involuntarily converted. An involuntary conversion may be the result of the destruction of property in whole or in part, the theft of property, the seizure of property, requisition or condemnation of property, or the threat or imminence of requisition or condemnation of property. Floods and fires are instances of involuntary conversion.

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[2] Bailey v. Commissioner, 88 T.C. 1293 (1987), held that the recipient of a facade grant lacked complete dominion and control over the facade because (i) the city's urban renewal agency chose the contractors and paid them directly, and (ii) the property owner was not allowed to alter the facade in any way and was required to grant the city an easement on the property. Accordingly, the cost of the new facade was not included in the recipient's income and was excluded from the property's basis. Contrastingly, in Grand Forks the business or property owner has control over the improvement project, including hiring the contractor and determining the scope of the project. Consequently, Bailey has no application to the Program.

An involuntary conversion may include a conversion into money. Section 1033(a)(2)(A) provides 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 the period specified in § 1033(a)(2)(B)), 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.

Here, a Program grant may serve two purposes. In general, a recipient of a Program grant receives the money in order to construct improvements on its property that the City determines are likely to contribute to revitalization of the downtown area. The City gives special consideration to the likelihood that the applicant will contribute to that revitalization. However, recovery from the flood is also one of the Program's goals. All properties eligible for grants have suffered partial destruction from flood damage, and the flood was the impetus for the federal appropriation funding the Program. Moreover, the flood damage to a property must be repaired before the improvements that the Program seeks to fund can be constructed.

Based on the overall context of the Program, including its goal of aiding recovery from flood damage, it is appropriate to consider the Program funds as received on account of the flood damage and to allow a taxpayer to elect § 1033 treatment to the extent that a taxpayer incurs costs to remediate the flood damage to the property covered by the grant. Program grant monies in excess of the flood damage to the property are income to the taxpayer under § 61(a) and Glenshaw Glass.

Discussion of Issue (2)

Section 165(a) permits a deduction for "any loss sustained during the taxable year and not compensated for by insurance or otherwise."[3] The point at which a loss is "sustained" is governed by § 1.165-1(d)(2)(i) of the Income Tax Regulations, which links the timing of a loss deduction with the possibility of reimbursement. Thus, § 1.165-1(d)(2)(i) provides that if a casualty or other event occurs which may result in a loss and, in the year of such casualty or event, there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery, no portion of the loss with respect to which reimbursement may be received is sustained, for purposes of section 165, until it can be ascertained with reasonable certainty whether or not such reimbursement will be received. Similarly, § 1.165-1(c)(4) provides that the amount of

[3] Section 165(c)(1) and (c)(2) limit losses taken by individuals to those incurred in a trade or business or in a transaction entered into for profit. Section 165(c)(3), (h), and (k) contain rules permitting individuals to deduct casualty and theft losses that are not covered by § 165(c)(1) or (c)(2). Section 165(c)(1) applies to the losses sustained by individuals receiving Program grants because those individuals were only eligible to receive such grants in connection with their trades or businesses.

insurance or other compensation received must be taken into account in determining the amount of loss actually sustained.

Section 1.165-1(d)(2)(iii) links a loss deduction with the tax benefit rule of § 111 in those circumstances in which a taxpayer deducts a loss in one year, derives a tax benefit from the deduction, and receives reimbursement for that loss in a subsequent taxable year. The tax benefit rule ordinarily requires the recognition of gross income in such cases because the receipt of the compensation is fundamentally inconsistent with the prior deduction. Hillsboro Nat'l Bank v. Commissioner, 460 U.S. 370 (1983), 1983-1 C.B. 50. The amount of the compensation is includible in gross income to the extent of the tax benefit derived from the deduction of the loss in the prior year. Id.; § 111; § 1.165-1(d)(2)(iii).

Because the existence of "compensation" under § 165(a) affects the extent and timing of a loss deduction (and has the potential of triggering tax benefit income), it is obviously important to determine whether grants made under the Program were "compensation" to the grant recipients. It is clear that, in appropriate circumstances, government funds earmarked and used to reimburse taxpayers for property damage attributable to a casualty can constitute compensation within the meaning of § 165(a). See, e.g., Londagin v. Commissioner, 61 T.C. 117 (1973) (federal and state funds used to reduce SBA mortgage balances on property damaged in an earthquake); Spak v. Commissioner, 76 T.C. 464, 467 (1981) (use of government funds to purchase flood-damaged property for its pre-casualty fair market value); Rev. Rul. 71-160, 1971-1 C.B. 75; Rev. Rul. 74-206, 1974-1 C.B. 198. Government payments for such casualty-caused property losses are in the nature of insurance because such payments have the effect of spreading the risk of specific losses among a large group of people, namely, taxpayers. Shanahan v. Commissioner, 63 T.C. 21, 23 (1974).

On the facts here, however, grants under the Program will generally not be compensation within the meaning of § 165(a). The Program's principal purpose is the economic development of downtown Grand Forks. Towards that end, grant money will be used to make downtown businesses more attractive, not to "replace what was lost." See generally Estate of Bryan v. Commissioner, 74 T.C. 725, 727-728 (1980); Rev. Rul. 87-117, 1987-2 C.B. 61 (rate increase did not constitute reimbursement for utility's loss on abandonment of power plant and did not, therefore, preclude loss deduction).

To the extent the Grand Forks commercial rehabilitation grants are not compensation for losses within the meaning of § 165(a), the tax benefit rule is not implicated. Because the receipt of the grant need not be taken into account in determining the amount of the loss deduction, there is no fundamentally inconsistent event that could trigger the application of § 111. Hillsboro Nat'l Bank, supra.

However, Program funds that are received on account of the flood damage must also be considered compensation for a loss within the meaning of § 165(a). Program funds are received on account of the flood damage to the extent that a taxpayer incurs otherwise unreimbursed costs to remediate the flood damage. It follows, from what has

previously been said, that to the extent the Program funds compensate the taxpayer for flood damage, the taxpayer is not entitled to a loss deduction. If, in a prior taxable year, the taxpayer properly took a casualty loss deduction for the flood damage, Program funds received on account of flood damage are considered a recovery of an amount previously deducted under § 165 and must be included in the taxpayer's income in the taxable year received to the extent required by tax benefit principles. See Hillsboro, supra, and Rev. Rul. 74-206 (to the extent a prior year casualty loss deduction resulted in a tax benefit, condemnation proceeds, to which § 1033 might otherwise apply, must be reported as ordinary income while remaining gain may be deferred under § 1033).

Discussion of Issue (3)

Section 162(a) generally permits a taxpayer to deduct the ordinary and necessary expenses paid or incurred in its trade or business. However, improvements of tangible property with a useful life extending beyond the taxable year must be capitalized under § 263. See §§ 1.263(a)-1(a)(1); 1.263(a)-2(a).

All of the costs of the improvements would be required to be capitalized, including those "soft costs," such as the design sketches, which are also part of the application process. Because the improvements are tangible property with a useful life extending beyond the taxable year, the costs of the improvements, including the soft costs, would be required to be capitalized under § 263. Treas. Reg. §§ 1.263(a)-1(a)(1); 1.263(a)-2(a).

Discussion of Issue (4)

If the grant were to consist of one or more payments over two or more tax years or if the taxpayer incurred application expenses in one taxable year and did not receive the grant money until the next taxable year, then in theory the costs, including soft costs of obtaining that income stream would be a capital expenditure (or a deferred expense). Thus, the answer to this question can vary depending upon the timing of the taxpayer's expenditures and its receipt of the grant proceeds, which may vary from taxpayer to taxpayer.

If the taxpayer's application costs are capitalized,[4] it would be entitled to amortize the capitalized costs over the life of the income stream. On the other hand, if the taxpayer's costs of preparing the application and receipt of the grant proceeds occurred in the same taxable year under that taxpayer's method of accounting, there is no income stream, and that taxpayer would not be required to capitalize the soft costs solely on the basis of their relation to the application process. However, the absence of a future

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[4] If the application costs are capitalizable, then the taxpayer would have to allocate between those application soft costs that are actually the soft costs of the improvements, such as architectural plans, and those that pertain only to the application (and the income stream created by the grant).

income stream does not mean that the application costs are automatically deductible. Some of what appear to be soft costs of the application process are really soft costs of the street level and facade improvements, which, as discussed previously, in Issue 3, are required to be capitalized, regardless of the timing of the incurring of the expenses and the receipt of the grant proceeds.

Moreover, given that under the Program procedures applicants are supposed to start construction of the improvements within 30 days of application approval and complete construction within 180 days of its start, it is unclear how likely it is that the grant proceeds would actually extend into the next taxable year.

We will be happy to provide further assistance if you need it in any specific case.

Discussion of Issue (5)

The grant recipients will take a cost basis in the improvements. In general, under § 1012 the basis of property is its cost. Section 1011 states, in part, that the adjusted basis of property shall be the basis determined under § 1012 adjusted as provided in § 1016. Section 1016(a) provides the general rule that proper adjustments in respect of property shall be made for expenditures, receipts, losses, or other items properly chargeable to a capital account. Section 1.1016-2(a) provides that the cost or other basis shall be properly adjusted for any expenditure, receipt, loss, or other item, properly chargeable to a capital account, including the cost of improvements and betterments made to the property. Therefore, to the extent that the expenditures made by the grant recipients are required to be capitalized (and are not subject to § 1033) those expenditures will increase the recipients' § 1012 cost basis in the property improved.

However, if the taxpayer elects § 1033 treatment for Program funds for costs incurred to remediate flood damage to the property, the basis of the property will be determined under § 1033(b)(2). 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.

Discussion of Issue (6)

Section 6041(a) generally requires all persons engaged in a trade or business and making payment in the course of such trade or business to another person, of fixed or determinable gains, profits, and income of $600 or more in any taxable year to file an information return with respect to such payments. Sections 1.6041-1(b)(1) and (g) provide that payments made by a state or a political subdivision are subject to this reporting requirement. Section 1.6041-3(e) (effective before January 1, 1999), and

§ 1.6041-3(q)(1) (effective after December 31, 1998), provide generally that payors are not required to file information returns for payments made to corporations.[5]

As used in § 6041, the term "gains, profits, and income" means an amount that is gross income to the payee. Section 1.6041-1(c) provides that income is fixed when it is to be paid in amounts definitely predetermined. Income is "determinable" whenever there is a basis of calculation by which the amount to be paid may be ascertained.

Rev. Rul 54-571, 1954-2 C.B. 235, holds that a real estate agent who withholds commissions in paying over rents collected on behalf of a property owner must nevertheless report on the gross amount of rents collected on behalf of the property owner because the commissions and other deductions are considered as having been paid to the owner and, in turn, paid back to the agent to discharge the owner's obligations to the agent.

Rev. Rul. 78-110, 1978-1 C.B. 390, provides that a mutual casualty insurance company is required file information returns in accordance with § 6041 to report hail crop insurance proceeds paid to farmers even though (because an election under § 451(d) might be made) the year in which such proceeds will be included in the farmer's income cannot be ascertained by the insurance company.

Rev. Rul. 80-22, 1980-1 C.B. 286, clarified Rev. Rul. 78-110 by holding that the company is not required to report the crop insurance proceeds if the farmer has informed the insurance company that expenses had been capitalized pursuant to either § 278 or § 447. In that case, whether a farmer has "gains, profits, or income," depends on the farmer's basis in the crops. Because the insurance company cannot require a farmer to disclose the basis in the destroyed crops, the amount of "gains, profits, or income," if any, resulting from the payment of the hail crop insurance proceeds is not fixed or determinable by the company. If, however, the farmer does not inform the insurance company that the expenses have been capitalized pursuant to either § 278 or § 447, the company is required to report the proceeds in accordance with § 6041.

Ordinarily, a government grant to a property owner to make improvements in connection with the government's economic development effort will be a payment of fixed and determinable gains, profits, or income for which § 6041 requires information reporting. See Rev. Rul. 78-110.

Here, however, in light of the flood and fire, the focus of the appropriation funding the Program on flood recovery, the limitation on eligible properties to properties that had been damaged in the flood and fire, and the need to remediate at least some of that damage in the course of constructing improvements funded by the Program, the City knew that the Program funded remediation costs to some extent. Absent actual

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[5] After 1998, § 1.6049-4(c)(1)(ii)(A), incorporated by reference in § 1.6041-3(q)(1), provides rules payors may use to determine that a payee is a corporation (absent actual knowledge to the contrary).

knowledge of the taxpayer's adjusted basis in the property and the remediation costs (as distinguished from the remaining costs of the improvements) the City could not determine the specific amount of the grant that is includible in a recipient's gross income. As the grant payment is therefore not fixed and determinable, no information reporting is required under § 6041. See Rev. Rul. 80-22.

If you find that the facts differ from those recited here, we will be happy to offer further assistance.

This technical assistance is advisory only, and is intended to call attention to well-established principles of tax law that apply in the situation described. 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. 99-1, 1999-1 I.R.B. 6, and Rev. Proc. 99-2, 1999-1 I.R.B. 73, respectively.