

STATEMENT

of

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on behalf of the

AMERICAN BAR ASSOCIATION
SECTION OF TAXATION

before the

COMMITTEE ON WAYS AND MEANS
SUBCOMMITTEE ON OVERSIGHT

of the

UNITED STATES HOUSE OF REPRESENTATIVES

on the subject of

CHARITABLE LOANS AND GRANTS TO BUSINESSES

November 8, 2001

Mr. Chairman and Members of the Subcommittee:

My name is Michael Hirschfeld. I appear before you today in my capacity as Chair of the 9/11 Tax Task Force of the American Bar Association Section of Taxation. This testimony is presented on behalf of the Section of Taxation. It has not been approved by the House of Delegates or the Board of Governors of the American Bar Association and, accordingly, should not be construed as representing the policy of the Association.

The Section of Taxation organized its 9/11 Tax Task Force in order to respond to legal questions and community needs within our Section's area of expertise. I am pleased to be serving as Chair of this Task Force. In the first weeks after the attacks, charities in New York, where I live and work, were seeing the need for relief to small and medium sized businesses affected by the attacks. As a result, the tax bar was being presented with questions about the tax consequences if businesses received grants and low interest loans from charities responding to community needs created by the attacks.

Our Task Force asked leading practitioners from our Exempt Organizations Committee to review the law in this area. We found that there is a sound basis in the law to exclude these relief payments from income. However, we also found some guidance previously issued by the Internal Revenue Service (the "IRS") that could have raised concerns on this point. We therefore concluded that new IRS guidance confirming the nontaxability of business relief payments would be materially helpful to September 11-related charitable relief efforts.

We made a submission to the IRS on October 15, as individual comments on behalf of members of our Task Force and the Exempt Organizations Committee, seeking immediate guidance. Consistent with Section policies on conflict of interest, the commenters were individuals whose firms were not assisting clients in seeking guidance on the same subject. When we were invited by this Subcommittee to discuss those comments, we took the additional procedural steps to authorize this testimony as testimony of the Section of Taxation. I hope the Subcommittee will understand that my ability to speak for the Section is limited to the areas covered in my prepared testimony.

Let me briefly review the state of the law that we found, and the IRS guidance we are seeking.

Needs-Based Relief Payments to Individuals Are Tax Free Gifts

The IRS has taken a clear and definitive position that relief payments awarded to individuals on the basis of need are excludable from income. Where the relief payment is made as part of a governmentally-authorized program, the IRS has ruled that the payment is excluded from the recipient's income under a principle known as the general welfare doctrine.¹ Where the payment is made by a nongovernmental Code

¹ See, e.g., Rev. Rul. 76-144, 1976-1 C.B. 17 (grant received under the Disaster Relief Act of 1974 is in the interest of the general welfare and not includible in an individual's gross income).

section 501(c)(3) charity, the IRS has ruled that “a payment made by a charity to an individual that responds to the individual’s needs, and does not proceed from any moral or legal duty, is motivated by detached and disinterested generosity,” and therefore is excludable from the individual’s income as a gift.²

Disaster Relief Grants to Businesses Appear To Be Tax Free Gifts; Clarification Needed

We believe that, as a matter of law and policy, the same principles described above for individuals should apply to grants to businesses. Thus, grants responding to need, not proceeding from duty, and motivated by detached and disinterested generosity, are properly treated as nontaxable gifts. This description clearly covers the typical charitable grant to a small or medium sized business affected by the September 11 attacks.

Several authorities provide support for this conclusion. For example, the Tax Court has found that contributions to an unincorporated association which were used to furnish bail for persons held in custody in certain types of cases were gifts and not includible in income.³ In a lengthy General Counsel Memorandum addressing the proper taxation of income received by an organization that had its exemption under Code section 501(c)(3) revoked, the IRS stated definitively that Code’s income exclusion for gifts is not limited in its application to gifts to individuals.⁴

However, we also found an IRS Chief Counsel Advice⁵ that failed to address the possible gift treatment of flood relief payments, although it could have. This document instead stated that such payments were includible in income under Code section 61 to the extent they did not reduce the taxpayers’ loss deductions under Code section 165 or the taxpayers did not elect nonrecognition under Code section 1033. This Chief Counsel Advice unfortunately could lead IRS agents to assert the taxability of disaster relief grants in the September 11 context.

² See Rev. Rul. 99-44, 1999-43 I.R.B.

³ Bail Fund of the Civil Rights Congress of N.Y., 26 T.C. 482 (1956).

⁴ See Gen. Couns. Mem. 39813 (Apr. 2, 1990). Section 2(b)(6)(a) of Gen. Couns. Mem. 39813 states as follows: “One possible position is that section 102 is restricted to gifts received by individuals, out of personal affection or charitable impulses, and simply does not apply to amounts received by an organization. We conclude, however, that at this point such a restriction would not be upheld by the courts. In Duberstein, the Court expressly refused to read an implicit restriction to individuals as donors into a statute that does not draw such a distinction by its terms.”

⁵ IRS Chief Counsel Advice 2000-32-041.

Relationship of Loss Deductions to Relief Grants

Code section 165 allows a taxpayer to deduct his or her losses to the extent the losses have not been compensated for by insurance or otherwise. Thus, for-profit business entities receiving grants from charities to compensate their losses will be required to reduce their deductible losses under Code section 165 by the same amount. We want to emphasize that this rule prevents any duplication of the tax benefit from the income exclusion. However, we believe that there are many business entities that have a low tax basis in their assets and thus may not have significant potential tax loss deductions. These businesses could incur significant tax liability unless there is clarification of the income exclusion for charitable disaster-relief payments.

Below-Market Loans -- IRS Should Clarify No Imputation Applies

The proceeds from a loan are not includable in a borrower's income.⁶ The IRS, however, has the authority under Code section 7872 to impute income to parties who borrow funds at a below-market rate of interest. The IRS has issued a private ruling stating that below-market loans undertaken as part of a government relief effort do not create this type of imputed income to the recipient business entities, because the loan programs were not established with the principal purpose of tax avoidance.⁷ We believe that the same policy and rationale should apply to below-market or interest-free loans made by nongovernmental Code section 501(c)(3) charities responding to the September 11th terrorist attacks. We therefore urge the IRS to confirm that the bargain element of below-market charitable relief loans made to for-profit business entities in connection with the September 11th terrorist attacks does not create income for the borrower.

Forgiveness of Disaster Relief Loans

The IRS has issued some private rulings indicating that amounts forgiven on certain government disaster-relief loans can create cancellation of indebtedness income for the borrower under Code section 108.⁸ These rulings could lead IRS agents to assert that forgiveness of loans made to relieve September 11 losses generates tax liability for the borrowing business. For the reasons discussed above, we believe that the cancellation of loans made by governmental entities and Code section 501(c)(3) charities for September 11 disaster relief should be properly viewed as gifts to the borrower. We therefore urge the IRS to confirm that cancellation of indebtedness income from loans to for-profit business entities forgiven by charities in connection with the September 11th terrorist attacks is not taxable.

⁶ See, e.g., E.C. Gatlin v. Commissioner, 34 B.T.A. 50 (1936); Rev. Rul. 70-266, 1970-1 C.B. 116.

⁷ Priv. Ltr. Rul. 1999-43-037 (Oct. 29, 1999) (analyzing government-financed loan programs created to provide financial assistance to companies affected by severe flood and fire damage).

⁸ See, e.g., Priv. Ltr. Rul. 1999-43-037 (Oct. 29, 1999).

Conclusion

We believe that disaster-relief payments made by Code section 501(c)(3) charities, whether in the form of outright grants, below-market loans, or loan forgiveness, are all in the nature of gifts. These payments are motivated by the involved charities' core missions and commitments to their respective communities, *i.e.*, the classic detached and disinterested generosity that is articulated in the seminal Duberstein case on gifts. The charities involved have no expectation of receiving any goods or services in return, nor do they expect to earn any income, let alone profit, from these activities. Therefore, the analysis of these disaster-relief payments by charities to for-profit business entities as gifts is consistent with the manner in which the IRS has evaluated payments of this kind when made to individuals (or in other contexts), which are treated as gifts.

Thus, we respectfully request that the IRS promptly confirm that charitable loans and grants provided by charities to for-profit business entities affected by the September 11th terrorist attacks do not produce taxable income for the recipients.

We believe that our requested clarifications are fully consistent with existing law, so that Congress does not need to change the law in these areas. However, Congress may wish to consider opportunities to clarify the law on these points, whether in actual legislation or in appropriate Committee report language.

We very much appreciate the interest of the Subcommittee in these important matters. Thank you for your attention.