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MEMORANDUM FOR MARY ENGDAHL
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FROM: Lewis J. Fernandez By: George Baker
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(Income Tax & Accounting)

SUBJECT: FEDERAL EMERGENCY MANAGEMENT AGENCY PAYMENTS—CERRO GRANDE FIRE—PROPERTY LOSS

This technical assistance memorandum is in response to your request dated November 22, 2000, regarding the tax treatment of certain payments that the Federal Emergency Management Agency (FEMA) may make to individuals and businesses in New Mexico that suffered losses due to the Cerro Grande Fire. These payments are authorized by the Cerro Grande Fire Assistance Act (the Act), Pub. L. No. 106-246, 114 Stat. 511. Technical assistance does not relate to a specific case and is not binding on directors (or their offices) or area directors, appeals, as those terms are described in Rev. Proc. 2001-2, § 1, 2001-1 I.R.B. 79 at 84. This document may not be cited as precedent.

ISSUES:

1. May a taxpayer entitled to claim damages under the Act claim a casualty loss deduction under § 165 of the Internal Revenue Code for damage to personal or business property?

2. May a taxpayer who receives damages under the Act elect under § 1033 to defer gain that would otherwise result from the conversion of property destroyed or damaged into money?

3. May a taxpayer whose principal residence is destroyed apply § 121 to exclude gain that would otherwise result and defer any remaining gain under § 1033?

CONCLUSIONS:

1. No. Taxpayers who suffered otherwise-deductible casualty losses as a result of the Cerro Grande fire have a reasonable prospect of recovering reimbursement for their losses under the claims settlement procedure set forth in the Cerro Grande Fire

Assistance Act, the Federal Tort Claims Act, or some other law. Consequently, the losses are not deductible under § 165.

2. Yes. Although the amount of compensation paid under the Act is, in general, gross income to the recipient taxpayers under § 61(a), a recipient whose property (other than inventory) was damaged as a result of the fire may elect, in accordance with § 1033, to defer recognition of gain to the extent the recipient expended an amount at least equal to the amount of the compensation received on account of that property damage to purchase qualified replacement property.

3. Yes. Section 121, which excludes from income a limited amount of the gain from the sale of a principal residence under certain circumstances, treats the destruction of a residence as a sale. A taxpayer may elect to defer additional gain under § 1033.

FACTS:

The Cerro Grande fire resulted from a prescribed fire ignited on May 4, 2000, by National Park Service fire personnel at the Bandelier National Monument, New Mexico. The fire ultimately burned more than 47,000 acres in four counties and the Pueblos of San Ildefonso and Santa Clara, and destroyed more than 200 residential structures. The severity of damage throughout northern New Mexico resulted in a Presidential Disaster Declaration. FEMA-1329-DR, 65 Fed. Reg. 32096 (May 22, 2000).

On July 13, 2000, President Clinton signed the Act into law. During calendar year 2000, FEMA issued interim final regulations, 45 C.F.R. § 295.1 *et seq.*, and made partial payments on claims, as authorized by Act § 104(d)(2) and § 295.6 of the regulations.

The stated purposes of the Act are to compensate victims of the fire for injuries and to provide expeditious consideration and settlement of claims for those injuries. Act § 102(b). The Act created within FEMA an Office of Cerro Grande Fire Claims, and requires that office to administer a program for fully compensating those who have suffered personal injury, property losses, business losses, and financial losses resulting from the fire. Act § 104(a)(1) explicitly states "[e]ach injured person shall be entitled to receive from the United States—(A) compensation for injury suffered by the injured person as a result of the Cerro Grande fire," as well as additional "damages" itemized in the legislation.[1]

The Act limits payments to compensatory damages, measured by injuries suffered.

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[1] The term "injury" is defined as including "loss of property." Act § 103(4).

Act § 104(c)(3). Specifically, the Act permits compensation for an uninsured or underinsured property loss. Act § 104(A)(1)(i). It also provides for damages for an uncompensated business loss of damage to tangible assets or inventory. Act § 104(d)(4)(B)(i). It does not permit payments for certain other types of damages, including punitive damages or interest before settlement. An individual seeking compensation under the Act for injuries resulting from the Cerro Grande fire makes a final and conclusive election not to file a claim against the United States for those injuries under chapter 171 of Title 28, United States Code (commonly known as the "Federal Tort Claims Act") or any other provision of law. Act §104(h).

LAW AND ANALYSIS:

1. Casualty Loss Deduction Under § 165

Section 165(a) of the Internal Revenue Code permits a deduction for "any loss sustained during the taxable year and not compensated for by insurance or otherwise."

Treas. Reg. §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 § 165, until it can be ascertained with reasonable certainty whether or not such reimbursement will be received.[2]

Treas. Reg. §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.

Thus, a taxpayer is not entitled to a casualty loss deduction to the extent a loss is compensated. Nor can a taxpayer deduct a casualty loss if the taxpayer has a reasonable prospect of recovery on a claim for reimbursement. If a deduction has been properly taken, any subsequent recovery of compensation must be reported as income

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[2] In the case of losses in areas determined to be federal disaster areas, taxpayers may elect to take casualty loss deductions in the year preceding the year of the disaster. Section 165(i)(1). However, in such cases, the deduction is limited to "the uncompensated amount determined on the basis of the facts existing at the date the taxpayer claims the loss." Section 165(i)(3). Thus, the fact that a casualty loss deduction might be taken in the year prior to the year of the casualty does not mean that the existence of a claim for reimbursement, existing in the year of the loss, is irrelevant.

under tax benefit principles. In applying these rules, it is necessary to determine whether a taxpayer is compensated within the meaning of § 165(a).

The Tax Court interpreted the estate tax counterpart to § 165(a) in Estate of Bryan v. Commissioner, 74 T.C. 725 (1980).[3] In that case, the taxpayer received money from a trust fund established to compensate individuals who had been defrauded by attorneys. The issue was whether the payment constituted compensation so as to preclude a loss deduction. In holding that the payment was compensatory and therefore reduced the allowable deduction, the court explained that the statutory language "insurance or otherwise" refers to payments that are "structured to replace what was lost" and that are "similar to insurance." 74 T.C. at 727-28.

In Revenue Ruling 71-160, 1971-1 C.B. 75, the Service concluded that a taxpayer received compensation within the meaning of § 165(a) to the extent that a Small Business Administration Loan had been canceled pursuant to the Disaster Relief Act of 1969. Because the loan had been made prior to enactment of the relief act, and the taxpayer could not have anticipated the debt cancellation, the casualty loss deduction had been properly taken. The debt cancellation, however, required that income be reported under tax benefit principles. See also Shanahan v. Commissioner, 63 T.C. 21 (1974).

Taxpayers who suffered losses as a result of the Cerro Grande, New Mexico, fire are not entitled to casualty loss deductions under § 165 because they have claims against the United States for reimbursement for their losses and there exists a reasonable prospect of recovery pursuant to those claims.

The legislation also makes it clear that the claims settlement procedure it establishes is not the exclusive procedure available for claims held by injured persons. It states that “the Secretary of the Interior and the National Park Service have assumed responsibility for the fire and subsequent losses of property.” Act § 102(a)(6). The legislation references the Federal Tort Claims Act. By pursuing the claims settlement procedure established by the legislation, persons release the United States from liability under the Federal Tort Claims Act. Act § 104(e)(2). Elsewhere, the legislation states that persons make a “final and conclusive” election by pursuing relief under the claims settlement procedure or by filing suit under the Federal Tort Claims Act or other law. Act § 104(h). The clear import of these provisions is that persons injured by the fire have claims not only under the claims settlement procedure but also under the Federal Tort Claims Act and possibly under other provisions of law. The law requires the claimant to elect one of the alternative claims.

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[3] The court commented that the provision should be interpreted in the same manner as § 165(a).

2. Nonrecognition of Gain Under § 1033

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 amount of the compensation received under the Act clearly falls within the § 61(a) and Glenshaw Glass definition of income, and generally is includible in the recipient's gross income, 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 the recognition of gain required by § 1001(c) is § 1033.

Section 1033 allows for the 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. Destruction of property by fire is one example of an involuntary conversion.

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, 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 qualified replacement property (property similar or related in service or use to the converted property).[4] 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 the replacement 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.

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[4] The unadjusted basis of qualified replacement property must be determined under § 1012. Section 1033(a)(2)(A)(ii). Thus, recognition of gain realized on the involuntary conversion of inventory cannot be deferred under § 1033 because the basis of any inventory purchased as replacement property would be determined under § 1013.

Here, the Act provides compensation for several categories of injuries incurred as a result of the fire. Those categories include damage to real or personal property,[5] business or financial loss,[6] and personal injury. Section 1033 does not apply to all these types of damage. Only those amounts received as compensation for damages to real or personal property would qualify under § 1033. Compensation for other types of damages, such as lost wages, lost business, or interest expense, do not constitute gain from the involuntary conversion of property and, thus, do not qualify for deferral under § 1033.

Moreover, to qualify for a deferral under § 1033, generally taxpayers must expend the amount received on qualified replacement property[7] within 2 years of the date the funds are received. However, where the gain results from the destruction (in whole or in part) of the taxpayer's principal residence as a result of a Presidentially declared disaster, such as the Cerro Grande Fire, certain exceptions to these rules apply.

Section 1033(h)(1)(A)(i) provides that if the taxpayer's principal residence or any of its contents is compulsorily or involuntarily converted as a result of a Presidentially declared disaster, no gain shall be recognized by reason of the receipt of insurance proceeds for personal property which was part of such contents and which was not scheduled for purposes of such insurance. In addition, insurance proceeds received on account of scheduled personal property or real property shall be treated as received from the conversion of a single item of property. This means that the amounts received for each item may be pooled together and any property purchased that is similar or related in service or use to the residence (or its contents) shall be treated as qualified replacement property. Section 1033(h)(1)(B) also extends the period of time in which replacement property must be acquired from 2 years to 4 years.

Under the Act, taxpayers are permitted to file a claim for damages with their insurance company and/or directly with the federal government. In the former case, the insurance company may file a claim for reimbursement with FEMA for any claims paid to insured taxpayers. Since compensation for damages to an insured's principal residence (or its contents) can be received from an insurance company as "insurance proceeds" or

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[5] Loss of property includes uninsured or under insured property loss, decrease in value of real property, damage to physical infrastructure, and cost resulting from lost tribal subsistence. See Act § 104(d)(4)(A).

[6] Business loss includes damage to tangible assets or inventory, business interruption, overhead costs, and wages for work not performed. See Act § 104(d)(4)(B). Financial loss includes increased mortgage interest costs, insurance deductible, temporary living or relocation expenses, lost wages or personal income, debris removal and other cleanup costs.

[7] Expenditures made to remove debris and to repair or replace damaged property are treated as amounts spent to purchase qualifying replacement property.

directly from the government, we believe that § 1033(h)(1) applies regardless of the avenue the taxpayer chooses. The application of § 1033(h)(1), however, is limited to payments received by insured homeowners to the extent of their coverage and would not apply to the payments received under the Act by uninsured homeowners.

Section 1033 also provides relaxed rules relating to purchase of qualified replacement property where the taxpayer's business or investment property is destroyed in a Presidentially declared disaster. Section 1033(h)(2) provides that if a taxpayer's property held for productive use in a trade or business or for investment is compulsorily or involuntarily converted as a result of a Presidentially declared disaster, tangible property of a type held for productive use in a trade or business shall be treated as property similar or related in service or use to the converted property. This rule offers relief to taxpayers by allowing them to reinvest their funds in any tangible business property without being forced to recognize gain. However, the replacement property must be tangible property held for productive use in a trade or business and not property held for investment. The replacement period for this property is only 2 years.

There are generally no tracing requirements with respect to the application of § 1033. Thus, if a taxpayer obtained a loan from another source, such as the Small Business Administration (SBA), and used the proceeds of that loan (which is not income under § 61(a)) to purchase qualified replacement property, the taxpayer would nevertheless be entitled to deferral under § 1033 with respect to the amount received under the Act, to the extent of the cost of the replacement property.

3. Application of § 121 to Destroyed Principal Residence

Section 121 provides rules under which gross income does not include gain from the sale or exchange of property if, during the 5-year period ending on the date of the sale or exchange, such property has been owned and used by the taxpayer as the taxpayer's principal residence for periods aggregating 2 years or more.

Under § 121(b), the amount of gain that may be excluded generally is limited to $250,000, but, in certain cases, married couples on joint returns may exclude up $500,000 of gain. Further, the exclusion of gain does not apply to any sale by the taxpayer if, in the 2-year period ending on the date of the sale, the taxpayer has applied the exclusion to any other sale.

Section 121(d)(5) provides special rules for involuntary conversions, which may apply to taxpayers whose principal residences were destroyed by the fire and replaced with insurance proceeds or a recovery under the Act. Section 121(d)(5) treats the destruction of property as the sale or exchange of property. Further, in applying § 1033, the section provides that the amount realized from the sale or exchange of property shall be treated as being the amount determined without regard to § 121, reduced by the amount of gain not included in gross income pursuant to § 121. Finally, the section provides that if the basis of the property acquired as a result of the involuntary conversion is determined (in whole or in part) under § 1033(b), then, for purposes of satisfying the requirements of § 121 (with respect to the acquired property), the taxpayer will be treated as owning and using the acquired property as the taxpayer's principal residence during any period of time that the taxpayer owned and used the converted property as the taxpayer's principal residence.

In other words, a taxpayer whose principal residence is destroyed in the fire and who meets all the requirements of § 121 may do the following regarding the gain resulting from converting the house into insurance proceeds or a recovery under the Act:

(1) exclude gain to the extent permitted by § 121;
(2) elect to defer any remaining gain by acquiring replacement property (including rebuilding) in a manner satisfying § 1033; and
(3) if gain is deferred under § 1033, treat the period of ownership and use of the newly acquired residence as including periods of use and ownership of the destroyed residence.

On October 10, 2000, the Internal Revenue Service published in the Federal Register (at 65 F.R. 60140) proposed regulations interpreting § 121 that contain an illustration of the operation of this provision. Although these regulations have no specific legal effect until adopted as final regulations, the example may be useful for its comprehensive illustration of these principles. The example follows:

(i) On February 18, 1999, fire destroys Taxpayer A's house that had an adjusted basis of $80,000. A had owned and used this property as her principal residence for 20 years prior to its destruction. A's insurance company paid A $400,000 for the house. Thus, A realized a gain of $320,000 ($400,000 - $80,000). On August 27, 1999, A purchases a new house at a cost of $100,000.

(ii) Because the destruction of the house is treated as a sale for purposes of § 121, A will exclude $250,000 of the realized gain from A's gross income. For purposes of § 1033, the amount realized is then treated as being $150,000 ($400,000 - $250,000) and the gain realized is $70,000 ($150,000 amount realized - $80,000 basis). A elects under § 1033 to recognize only $50,000 of the gain ($150,000 amount realized - $100,000 cost of new house). The remaining $20,000 of gain is deferred and A's basis in the new house is $80,000 ($100,000 cost - $20,000 gain not recognized).

(iii) A will be treated as owning and using the new house as A's principal residence during the 20-year period that A owned and used the destroyed house.

We hope this memorandum is helpful. If you have any further questions, please contact George Baker at (202) 622-4920.