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MEMORANDUM FOR MARY ENGDAHL
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SUBJECT: FEDERAL EMERGENCY MANAGEMENT AGENCY PAYMENTS—CERRO GRANDE FIRE — FLOOD INSURANCE AND CLAIM EXPENSES

This technical assistance memorandum is in response to your request dated November 22, 2000, as supplemented by your requests dated March 6, 2001, and March 19, 2001, 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. Must a homeowner include in income a reimbursement from FEMA for the cost of the homeowner's flood insurance premium?

2. Must a claimant under the Act include in income FEMA's payments for claim preparation expenses?

3. Does § 1033(h)(1) apply to exclude gain resulting from insurance proceeds received for unscheduled personal property that was destroyed in a Presidentially declared disaster even though the property was not physically located in the taxpayer's principal residence at the time it was destroyed?

4. Must a claimant include in income insurance proceeds or FEMA payments received under the Act for inventory destroyed in the fire?

CONCLUSIONS:

1. A homeowner need not include in income a payment received under the Policies of the Office of Cerro Grande Claims to cover the homeowner's expenses of paying a premium for flood insurance for the home.

2. A claimant should treat FEMA's payments for claim preparation expenses as additional amounts received from FEMA. However, the claim preparation expenses incurred by the claimant are also treated as reductions in the total amount received in determining the amount realized for purposes of determining any gain on damaged or destroyed property.

3. Although § 1033(h)(1) refers to a taxpayer's principal residence "or any of its contents," the legislative history indicates that Congress meant to include all of a taxpayer's personal property associated with its principal residence, whether or not the property was actually located inside the principal residence at the time of its destruction. Accordingly, gain resulting from insurance proceeds received for unscheduled personal property that was destroyed in a Presidentially declared disaster may be excluded from income, even though the property was not physically located in the taxpayer's principal residence at the time it was destroyed.

4. Whether a claimant recognizes gain due to the receipt of insurance or FEMA payments for inventory destroyed in the fire depends both upon whether the amount received exceeds the basis of the inventory and whether the taxpayer elects to defer 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 (OCGC), 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.

The Act limits payments to compensatory damages measured by injuries suffered. Act § 104(c)(3). Section 104(d)(4)(B)(i) authorizes FEMA to pay compensation for uncompensated losses for "Damage to tangible assets or inventory."

Section 104(d)(4)(C)(viii) of the Act authorizes FEMA to pay compensation for specified uncompensated financial losses for "A premium for flood insurance that is required to be paid on or before May 12, 2002, if as a result of the Cerro Grande fire, a person that was not required to purchase flood insurance before the Cerro Grande fire is required to purchase flood insurance." The Policy Guidelines of the Office of Cerro Grande Claims for payment of flood insurance premiums provide that the office will reimburse "any flood insurance premium due and payable on or before May 12, 2002, for any property owner concerned about being at risk as a result of the Cerro Grande Fire, whether or not flood insurance purchase has been required by a lender or other authority." The payment will not be made if the claimant either had flood insurance before the fire or was required to have flood insurance, but did not.

Implementing regulations at § 295.31 also provide that FEMA will reimburse Claimants for the reasonable costs they incur in copying documentation requested by OCGC. FEMA will also reimburse Claimants for the reasonable costs they incur in providing appraisals, or other third-party opinions, requested by OCGC. FEMA will not reimburse Claimants for the cost of appraisals, or other third party opinions, not requested by OCGC. Under policies of the Office of Cerro Grande Fire Claims, at § 295.21(a), FEMA will pay some claimants 1% of the claim, up to $3,000, in order to cover the claimant's expenses of preparing the claim.

The Act 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. Flood Insurance

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.

Section 262 provides that except as otherwise provided for in this chapter, no deduction shall be allowed for personal, living, or family expenses. Section 1.262-1(b) further provides some examples of personal, living and family expenses such as (1) premiums paid for life insurance by the insured, (2) cost of insuring a dwelling owned and occupied by the taxpayer as a personal residence, and (3) expenses of maintaining a household.

In this case, homeowners not required to have flood insurance may, as a result of the fire, believe such insurance is now necessary. This need may be attributable to the fire’s destruction of vegetation throughout the area, which may have increased the risk of future flooding. The reimbursement could be seen as the government’s direct provision of a substitute for the protection previously provided by the now-burned vegetation; thus, it is a reimbursement for a cost that would not have been incurred were it not for the damage caused by the government’s action or inaction. Equally, it might be seen as a means of restoring the pre-fire value of flood protection afforded by vegetation that was destroyed by the Cerro Grande fire. Viewed in this light, the insurance premiums resemble replacement property and the reimbursements resemble additional compensation for the damaged property. Regardless of the view adopted, we believe that under the unique circumstances in which this reimbursement is paid, the government’s reimbursements of flood insurance premiums need not be treated as gain.

2. Payments for claim expenses.

Under implementing regulations, FEMA has undertaken to bear the cost, through reimbursement, of any documentation specifically required of claimants by FEMA. FEMA has also made clear that it will not reimburse claimants for any expenses incurred that were not specifically requested by OCGC. In addition, under policies of

the Office of Cerro Grande Fire Claims, FEMA will pay some claimants 1% of the claim, up to $3,000, in order to cover the claimant's expenses of preparing the claim.

These payments may appropriately be treated as additional amounts received on account of the claim. In order to receive those amounts, the claimant may be put to some specific expense, such as for documentation required by FEMA or such as payments that can be substantiated as being for expenses of preparing the claim, including, for example, fees to third parties for their expertise. In the case of Cerro Grande Act payments, it therefore seems that such costs of claimants may be treated as an adjustment to the total amount they receive in order to arrive at the amount realized for purposes of determining gain on the destruction of property to which the payment may relate. Since gain (if any) resulting from converting the property into the payment from FEMA is determined in the same manner as if the property had been sold, offsetting the expenses of making the claim against the claim proceeds may be viewed as similar to a selling expense that would be offset against proceeds if the property had been sold instead of being damaged or destroyed. Accordingly, under the specific facts presented by the Cerro Grande Act, while the reimbursements of claim expenses constitute an additional amount received, the Service should permit payments that can be substantiated as being for expenses of preparing the claim to be treated also as reducing the total amount received in determining the amount realized for purposes of determining any gain on damaged or destroyed property.

3. Payment for contents not located in the residence.

Section 1033(h)(1)(A) provides special rules for principal residences and personal property destroyed as a result of a Presidentially declared disaster. Section 1033(h)(1)(A)(i) provides for the nonrecognition of gain by reason of receipt of insurance proceeds for unscheduled personal property which was part of the "contents" of a taxpayer's principal residence. Other personal property of a taxpayer, i.e., property not located in the principal residence, which might be involuntarily converted by the same disaster, is not specifically mentioned in the statute.

Although a literal reading of the statute might lead to the conclusion that insurance proceeds for such personal property is not subject to the gain exclusion, we believe Congress did not intend to exclude any personal property, customarily insured as unscheduled personal property on a homeowner's or renter's policy, merely because it was not physically located in the residence when it was destroyed.

Section 1033(h) was added to the Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, just prior to the bill's finalization by the Conference Committee. This provision was first introduced in 1992, as part of H.R. 11, which was vetoed by the President on other grounds. It was also introduced in 1993 as S. 364. The provision contained in these earlier bills was incorporated into Pub. L. No. 103-66 with virtually

no changes. In describing the earlier Senate version of the provision, Senator Feinstein stated:

> [T]his legislation would exclude capital gains on any unscheduled personal property. Insurance proceeds rarely if ever reimburse a taxpayer fully for their loss and this would minimize the recordkeeping involved in listing losses of all personal property and the replacement cost of normal household property. . . .

139 Cong. Rec. 15 (February 16, 1993). Senator Feinstein's remarks suggest that Congress was concerned with allowing taxpayers to replace "normal household property" with a minimum of record keeping and without having to report capital gains when they are usually not reimbursed fully for their losses.

Many individuals have "normal household property" which they do not routinely keep in their homes. For example, some individuals may store their golf clubs or baby strollers in the trunks of their cars. Additionally, some individuals may keep radios or exercise equipment at their offices. If a homeowner's or renter's policy covers such items when they are not physically located in the principal residence, and they are destroyed in a Presidentially declared disaster, then a taxpayer should not be denied the gain exclusion of § 1033(h)(1)(A) simply because an item was in the trunk of a car or on the desk at work instead of in the basement or attic of his or her principal residence.

4. Payments for destroyed inventory

Section 61(a) of the Internal Revenue Code provides generally that gross income means all income from whatever source derived. However, with regard to manufacturing, merchandising, or mining businesses the term "gross income" means the total sales, less cost of goods sold, plus any income from investments and from incidental or outside operations or sources. See Treas. Reg. § 1.61-3(a). A taxpayer determines its costs of goods sold during a year by subtracting inventory on hand at the end of the year from the sum of the inventory on hand at the beginning of the year and the cost of purchases. See Rotolo v. Commissioner, 88 T.C. 1500, 1514-1515 (1987).

In footnote 4 of our memorandum in WTA-N-130562-00, dated February 15, 2001, we indicated that § 1033 is not available for deferring gain recognized on involuntary conversions of inventory. We have reconsidered this issue, and under these circumstances now believe the better technical view to be that a taxpayer who receives insurance or other proceeds for involuntarily converted inventory may elect to defer recognition of any resulting gain as provided in § 1033. If, however, gain is recognized, it will result in ordinary income rather than capital gain because § 1221(a)(1) explicitly excludes inventory from the definition of capital asset. Nor would the gain qualify as

§ 1231 gain treated as capital gain because § 1231(b)(1)(A) excludes inventory from the type of property that gives rise to § 1231 gain.

Accordingly, the determination of whether a taxpayer recognizes gain due to the receipt of insurance proceeds or FEMA payments under the Act connected with destroyed inventory depends both upon whether the payments exceed the basis of the inventory and whether the taxpayer elects to defer gain under § 1033.

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