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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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MEMORANDUM FOR MARY ENGDAHL
TAX SPECIALIST (SB/SE:TEC)

FROM: Lewis J. Fernandez
Deputy Associate Chief Counsel
(Income Tax & Accounting)

SUBJECT: FEDERAL EMERGENCY MANAGEMENT AGENCY (FEMA)
PAYMENTS FOR LIVING EXPENSES—CERRO GRANDE FIRE

This technical assistance request is in response to your request for assistance dated November 22, 2000, augmented by your request dated February 5, 2001, regarding the tax treatment of certain payments that individuals in New Mexico who suffered losses due to the Cerro Grande Fire have received from FEMA or their insurers. Payments for losses are authorized by the Cerro Grande Fire Assistance Act (the Act), Pub. L. No. 106-246, 114 Stat. 511. As discussed below, some payments made under the Act may also be authorized by the Robert T. Stafford Disaster and Emergency Assistance Act, 42 U.S.C. § 5121 et seq. (the Stafford Act). Technical assistance does not relate to a specific case and is not binding on directors (or their officers) 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 is not to be cited as precedent.

ISSUES:

Is a payment for additional living expenses occasioned by the loss of use of the recipient's home while evacuated (or as a result of the home's destruction) due to the fire included in the income of a recipient who:

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- (1) collects such amount from his or her insurance company,
- (2) collects such amount from FEMA in lieu of collecting from the insurance company,
- (3) is uninsured, or
- (4) is underinsured.

CONCLUSIONS:

(1) A payment of living expenses received from an individual's insurer is excludable from gross income under § 123 to the extent that the household's actual living expenses incurred for the period of loss of use exceed the household's normal living expenses that would have been incurred for such period.

(2) A payment of living expenses received by an insured individual directly from FEMA (in lieu of collecting from an insurance company) is also excludable from gross income to the extent described in § 123.

(3) and (4) For payments by FEMA for living expenses of a Cerro Grande Fire claimant who is either uninsured or underinsured, we believe the wise administration of the tax laws requires that the Service not pursue inclusion of those payments in income, so long as it is evident that the payments relate to necessary expenses directly attributable to the disaster.

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). This notice indicated that funds allocable to the disaster housing program may be expended in providing assistance authorized under the Robert T. Stafford Disaster and Emergency Assistance Act, 42 U.S.C. § 5121 *et seq.* (the Stafford Act).

In an effort to redress further the damage, Congress passed, and, on July 13, 2000, President Clinton signed, the Cerro Grande Fire Assistance Act. During calendar year 2000, FEMA issued interim final regulations, now found at 45 C.F.R. § 295.1 *et seq.*,

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and made partial payments on claims, under authority of 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 for 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. The Act limits payments to compensatory damages measured by injuries suffered. 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).

The Act specifically mentions as a compensable loss “A temporary living or relocation expense.” Act § 104(d)(4)(C)(iii). The Act’s implementing regulations at 45 C.F.R. § 295.1 *et seq.* do not further discuss payment of temporary living or relocation expenses. Those regulations do, however, at 45 C.F.R. § 295.21 deny compensation under the Act for emergency costs that have been reimbursed under the Individual and Family Grant Program or any other FEMA Individual Assistance Program, which includes temporary housing assistance provided under the Stafford Act.

The Cerro Grande Fire Assistance Act provides that the establishment of an office to receive, process, and pay claims under the Act does not diminish FEMA’s ability to carry out its responsibilities under the Stafford Act (42 U.S.C. § 5121 *et seq.*). Section 104(a)(2)(c)(v). Under § 408 of the Stafford Act, 42 U.S.C. § 5174, the President, acting through FEMA, under subsection (a), may provide suitable rental or other temporary housing to persons who, as a result of a major disaster, require temporary housing; under subsection (b), may provide assistance on a temporary basis to or on behalf of individuals and families who, as a result of financial hardship caused by a major disaster, have received written notice of dispossession or eviction from a residence; and, under subsection (c), may expend funds to restore to habitable condition owner-occupied private residential structures made uninhabitable by a major disaster. Payments under the Stafford Act are based on the recipient’s necessary expenses or serious needs created by disaster-related unlivability of a primary residence or other disaster-related displacement, combined with a lack of insurance coverage. 44 C.F.R. §206.101(b). To avoid duplication of benefits, the same section of the implementing regulations provides, at paragraph (d), that insured applicants will receive assistance only if insurance benefits are significantly delayed, exhausted, or insufficient, or if housing is not available in the local market. Assistance will be

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provided for up to 18 months. Thus, FEMA may have two statutory grants of authority to pay living expenses as a result of this fire.

Under the Act, payment on a claim shall be reduced by the insurance benefits or other payments or settlement of any nature that were paid, or will be paid, with respect to the claim. Act § 104(d)(1)(c). If an insurer or other third party pays any amount to a claimant to compensate for an injury described in the Act, the insurer or other third party shall be subrogated to any right that the claimant has to receive payment under this title or any other law. Under policies of the Office of Cerro Grande Fire Claims, at § 295.21(j), a claimant may withdraw an insurance claim before any compensation is paid and receive compensation under the Act for all damages.

LAW AND ANALYSIS:

Section 61(a) of the Internal Revenue Code provides generally that, except as otherwise provided by law, gross income includes all income from whatever source derived.

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.

Section 123 provides a limited exclusion from income for certain amounts received under an insurance contract as reimbursement for excess actual living expenses.

Section 123(a) provides that, in the case of an individual whose principal residence is damaged or destroyed by fire, storm, or other casualty, or who is denied access to his principal residence by governmental authorities because of the occurrence or threat of occurrence of such a casualty, gross income does not include amounts received by such individual under an insurance contract which are paid to compensate or reimburse such individual for living expenses incurred for himself and members of his household resulting from the loss of use or occupancy of such residence.

Section 123(b) limits the exclusion to amounts received by the taxpayer for living expenses incurred during any period only to the extent the amounts received do not exceed the amount by which (1) the actual living expenses incurred during such period for himself and members of his household resulting from the loss of use or occupancy of their residence, exceed (2) the normal living expenses which would have been incurred for himself and members of his household during such period. The increase in

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living expenses is determined when the taxpayer regains use of a principal residence, rather than at the end of each intervening tax year. See Rev. Rul. 93-43, 1993-2 C.B. 69.

Section 1.123-1(a)(5) of the Income Tax Regulations provides that the portion of any insurance recovery for increased living expenses which exceeds the limitation set forth in § 123(b) shall be included in gross income under section 61 of the Code.

Section 1.123-1(b)(1) of the Income Tax Regulations explains that the excludable amount generally represents such excess expenses incurred by reason of the casualty, or threat thereof, for renting suitable housing and for extraordinary expenses for transportation, food, utilities, and miscellaneous services during the period of repair or replacement of the damaged principal residence or denial of access by governmental authority.

Section 1.123-1(b)(2) explains that the actual living expenses are the reasonable and necessary expenses incurred as a result of the loss of use or occupancy of the principal residence to maintain the insured and members of his household in accordance with their customary standard of living. This generally includes the costs during the loss period of temporary housing, utilities furnished at the place of temporary housing, meals obtained at restaurants which customarily would have been prepared in the residence, transportation, and other miscellaneous services.

Section 1.123-1(b)(3) specifies that if any normal living expense is not incurred, or is reduced, this must be taken into account in determining the excludable amount.

Issue (1)

The amounts paid to recipients who collect only their additional living expenses from their insurance company because of the loss of use of their home due to the fire are received under an insurance contract. Accordingly, such amounts are excluded from gross income as provided in § 123. The specific amount excludable is determined under § 123(b), as described above. If the amount an individual receives from the insurance company for actual living expenses incurred during loss of use of the home exceeds the amount the individual may exclude, the excess must be included in gross income. This conclusion is based, in part, on our understanding that the Stafford Act generally does not permit payment of benefits to insured applicants except in extraordinary circumstances.

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Issue (2)

Insurance companies paying claims for additional living expenses under policy provisions are subrogated to the claims of the insured, and FEMA will ultimately bear the responsibility for the claim, whether paid directly to claimants or indirectly to insurers or others subrogated to the rights of such claimants. Perhaps in light of this, the policies of the office paying these claims state that individuals who have not collected from their insurance companies may proceed directly to claim compensation from FEMA. For this reason, we believe that the tax consequences to an insured individual of receiving payments from FEMA, as opposed to from the individual's insurer, should not be distinguished. Thus, insured individuals who obtain payment within the limits of their policies directly from FEMA should apply the provisions of § 123 to exclude some or all of those payments. Again, this conclusion is based, in part, on our understanding of FEMA's administration of the two acts with regard to the insured.

Issues (3) & (4)

Section 123 excludes from income certain payments received under the recipient's own insurance policy; this exclusionary provision is inapplicable to uninsured individuals who receive additional living expense reimbursements from FEMA and to payments received by underinsured individuals to the extent their insurance policies would not have covered the increased living expenses incurred due to the fire. The law requires that exclusions from income generally are strictly construed. *United States v. Centennial Savings Bank FSB*, 499 U.S. 573 (1991). Thus, we believe that § 123 does not apply to payments of living expenses received by uninsured and underinsured individuals from FEMA under the Act's authority. The payments by FEMA cover expenses that, by virtue of § 262, are not deductible as family, living, or personal expenses. See Rev. Rul. 59-398, 1959-2 C.B. 76. Payments for living expenses not falling within § 123 appear to be taxable. *Millsap v. Commissioner*, 46 T.C. 751 (1966), *aff'd*, 387 F.2d 420 (8th Cir., 1968); *McCabe v. Commissioner*, 54 T.C. 1745 (1970).

After concluding that, on a plain reading, the exclusion in § 123 is not available to exclude any amount received for living expenses by the underinsured and uninsured, we carefully and exhaustively searched for another exclusionary provision of law or doctrine that could be available to assist those uninsured and underinsured individuals who were damaged by this tragic circumstance. As we have noted, the Cerro Grande Fire Assistance Act is not the only authority FEMA may exercise in responding to the Cerro Grande Fire. In addition to its authority to pay temporary living expenses under the Act, FEMA is authorized, under the Stafford Act, to provide housing assistance on a

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temporary basis, not exceeding 18 months. In this regard, we have considered whether the General Welfare exception, a narrowly-construed administrative exception to the broad sweep of § 61, might apply in these circumstances.

In applying the General Welfare exception, the Internal Revenue Service has held that payments under legislatively provided social benefit programs for the promotion of general welfare are not includable in an individual's gross income. In determining whether the general welfare exception applies to particular payments, the Internal Revenue Service generally requires that the payments (1) be made from a governmental general welfare fund; (2) be for the promotion of the general welfare (*i.e.*, on the basis of need rather than to all residents without regard to, for example, financial status, health, educational background, or employment status) and (3) not be made with respect to services rendered by the recipients.

For example, in Rev. Rul. 76-144, 1976-1 C.B. 17, the Service held that a grant not exceeding \$5,000 under the Disaster Relief Act of 1974 to help an individual or family affected by a disaster to meet extraordinary disaster-related necessary expenses or serious needs (*e.g.*, medical or dental, housing, personal property, transportation, and funeral expenses) is in the interest of the general welfare and not includable in the recipient's gross income under § 61. The grant program considered in that ruling was intended to assist individuals and families unable to meet such expenses through other governmental assistance or from other means but was not intended to indemnify all disaster losses or to purchase items and services that may generally be characterized as nonessential, luxury, or decorative.

Unlike the situation in Rev. Rul. 76-144, the Cerro Grande Fire Assistance Act appears intended to provide compensation for, and a comprehensive resolution of, all losses or injuries from the fire specified in the Act, without regard to the recipient's other resources. In addition, claims under the Act constitute a final and conclusive election not to file a claim against the United States for those injuries under the Federal Tort Claims Act. We are not aware of a situation in which the Service has applied the general welfare exception to payments that are a comprehensive resolution of the recipients' claims conditioned on recipients' relinquishing their right to bring legal action against a governmental entity they may allege is a tortfeasor. Therefore, it appears that the better rule to apply in this situation is that the receipt of payments from FEMA for living expenses is a substitute for a judgment for those amounts against the United States or a settlement in like amount with the United States for damages caused by the government. *Hort v. Commissioner*, 313 U.S. 28 (1941); *Raytheon Production Corp. v. Commissioner*, 144 F.2d 110 (1st Cir. 1944) (The taxation of damages received is generally determined by the tax treatment of the payments for which they are a substitute.)

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Nevertheless, we believe the fact that living expenses could be paid to the uninsured and underinsured pursuant to FEMA's authority under the Stafford Act make the taxation of these specific payments an exceedingly close question; an impartial finder of fact could reasonably find that the payments are made under FEMA's disaster relief authority and are payments for the promotion of the general welfare. We find an added hazard in the fact that, under what we believe is the technically correct analysis set forth above, similarly situated individuals may be faced with diametrically opposite tax consequences depending upon whether the individuals are insured, on the one hand, or are underinsured or uninsured. Accordingly, we believe that it would be inadvisable to pursue this issue for payments within the Stafford Act authority in circumstances like those described in Rev. Rul. 76-144, involving payments covering disaster-related necessary expenses or serious needs during the repair or replacement of the damaged residence. We believe it would be appropriate for Service officials to indicate publicly that the Service generally will not require inclusion in income with respect to FEMA's living expense payments to Cerro Grande Fire Assistance Act claimants, at least during the period of the Stafford Act authority to make such payments, so long as it is evident that the payments relate to necessary or additional expenses directly attributable to the disaster. We believe, however, that the Service need not apply this advice not to require inclusion if amounts are received for luxuries or for normal living expenses of an individual who has abandoned efforts to re-occupy a dwelling comparable to the one whose occupancy or use was denied by the fire.

Even if excluded from income, however, to the extent that payments compensate the recipients specifically for medical expenses, the payments do reduce the amount of the recipients' deductions under § 213(a) for such expenses (see Rev. Rul. 76-144).

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