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Anatomy of a Disaster under the Internal Revenue Code

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I. INTRODUCTION

It might have been the howl of whipping winds; or the crackle, snap, pop of sizzling cinders; or the stench of smoke that woke them into the nightmare of 3:00 a.m. on October 26, 2003.[1] They awoke on Wildcat Canyon Road surrounded by their woods and the Cleveland National Forest engulfed in a firestorm.[2] Lonnie and Lori Bellante and their teenage daughters, Melanie and Lindi, raced from their third-generation homestead to the family Ford to escape threatening flames.[3] The heat, registering hundreds of degrees, melted the truck's tires and set it ablaze.[4] The family surrounded by hundreds of burning trees somehow found a small clearing.[5] Huddled together, they buried their sweaty faces and burned bodies in the dirt and waited.[6] For four incessant hours, the wildfire that consumed everything but their lives, raged around them.[7] Finally, the Bellante family stumbled to their feet, shocked and exhausted they began to grasp the horror that surrounded them. Even though they lost everything, the Bellantes are reminded daily by the absence of eight neighbors how lucky they are to have survived this disaster.[8]

1. See Jane Clifford, San Diego County Firestorms Aftermath: Building a Future, first in occasional series, The San Diego Union-Trib., Dec. 28, 2003, at E1, E4 (describing the narrow escape from the firestorm of 2003 by the Bellante family and their devastating loss of everything, but their lives).

2. Id.

3. See Id., at E4 (waking their eleven and thirteen year-old daughters they hustled into their truck and drove down the dirt road to escape the firestorm).

4. See id. (facing a wall of flames they made a quick, impossible turn to retreat, but soon the lack of oxygen stalled the truck's engine and they had to abandon the flaming vehicle).

5. See id. (surmising that the small area that saved their lives must have been cleared of trees and brush for a trailer).

6. See id. (acknowledging that "[w]e were going to live together, or die together,").

7. See id. (recounting how the firestorm melted the skin off Lori Bellante's arm and then raged around them for four endless hours).

8. See Janine Zuniga, San Diego County Firestorms Aftermath: Eight Lives Lost in Small Community Near Barona, Neighbors Killed Trying to Evacuate Homes, Others Barely Escaped, The San Diego Union-Trib., Nov. 2, 2003, at A10 (describing the tragic loss of eight of the Bellante's neighbors in the firestorm they barely escaped).

Each year disasters affect millions of innocent victims like the Bellantes.[9] Earthquakes,[10] floods,[11] drought,[12] fires,[13] tornadoes,[14] cyclones,[15]

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9. See Federal Emergency Management Agency, FEMA Brochure, available at http://www.fema.gov/pdf/library/thisisfema.pdf (last visited Feb. 17, 2005) (noting that "Disasters can strike at any time, any where . . . They can be an act of nature or an act of terrorism. They can strike suddenly, or build over days and weeks before bringing catastrophe. No matter how they come, disasters put millions of Americans in danger every year, and destroy billions of dollars worth of property.); International Federation of Red Cross and Red Crescent Societies, World Disasters Report 2002, 10, 37, 171-72, 187 (Table 1) (reporting that over the past thirty years the number of people impacted by disasters has increased dramatically; in 2001, 170 million people worldwide (11.2 million in the Americas) were affected by disasters – below the decade's average of 200 million but significantly greater than the 74 million average during the 1970s).

10. Over the last decade, earthquakes have been the most expensive of all disasters, with a worldwide price tag of $238 billion in damages ($39.6 billion in the Americas), without including any effect on the economy. World Disaster Report 2002, supra note 9, at 172, 192 (Table 8). During 2001, earthquakes affected 19 million people, more than any other year of the decade. Id. at 172, 191 (Table 7). On January 17, 1994, a killer earthquake rocked Northridge, California and cost $17.3 billion in insured losses. This disaster was the third most costly catastrophe in the United States and the world. See Insurance Information Institute, Facts and Statistics: Catastrophes, The Ten Most Costly World Insurance Losses, at http://www.iii.org/media/facts/statsbyissue/catastrophes (last visited June 30, 2004). Earthquakes account for approximately 9.8% of inflation-adjusted U.S. catastrophic losses. Id.

11. "Floods cause more destruction in the U.S. than any other disaster." FEMA Brochure, supra note 9 (commenting that flood damage is not covered by regular homeowners or renters insurance, but that FEMA's offers federally backed flood insurance coverage to residents in more than 19,000 communities). Floods have cost the world almost $192 billion ($36.4 billion in the Americas) over the last decade and have caused the broadest impact on people's lives accounting for almost two-thirds of people affected by disasters worldwide. World Disaster Report 2002, supra note 9, at 172 (Figure 8.2), 196 (Table 12). The number of floods and windstorms is 64% of all natural disasters and 35% of all disasters. Id. at 189 (Table 5). In 2000 and 2001, there were more than 150 floods worldwide. Id.

12. Drought/famine have cost the world more than $32.5 billion ($3.5 billion in the Americas) over the last decade and affected over 86 million people worldwide in 2001. Id. at 172, 191 (Table7), 196 (Table 12). Over the last decade, drought/famine was pervasive affecting 82% of all disaster victims in Africa; 48% in Oceania; and 35% in the Americas. Id. at 172, 195 (Table 11).

13. Forest/scrub fires have cost the world more than $25 billion ($3.6 billion in the Americas) worldwide. Id. at 196 (Table 12). "America's fire death rate is one of the highest per capita in the industrialized world. Fire kills more than 4,000 and injures more than 23,000 people each year. . . . Direct property losses due to fire exceed $8.5 billion a year." FEMA Brochure, supra note 9; see also Insurance Information Institute, Facts and Statistics: Catastrophes: Catastrophic Wildland Fires In the United States at http://www.iii.org/media/facts/statsbyissue/catastrophes (last visited June 30, 2003). "Fires have been growing bigger and badder. . . . [e]xploding out of forest tinderboxes, megafires are lethal, fast-moving and spread to more than 100,000 acres." Micah Morrison, Danger: Flames Ahead!, Parade, June 27, 2004, at 5 (describing the increased threat of fire to property and life).

14. Tornadoes account for more than 32% of the inflation-adjusted catastrophic losses in the United States. Insurance Information Institute, Facts and Statistics: Catastrophes, at http://www.iii.org/media/facts/statsbyissue/catastrophes (last visited June 30, 2004) (charting catastrophic losses and ranking the ten most costly tornadoes in the United States).

15. All tropical cyclones (including hurricanes and tropical storms) account for 28% of all inflation-adjusted catastrophic losses in the United States. See Insurance Information Institute, Facts and Statistics: Catastrophes: Inflation-Adjusted U.S. Catastrophe Losses by Category, at http://www.iii.org/media/facts/statsbyissue/catastrophes (last visited June 30, 2004) (charting inflation-adjusted catastrophic losses

hurricanes[16] and terrorism[17] account for billions of dollars of direct damage annually.[18] The terrorist attacks on September 11, 2001 resulted in unparalleled,

in the United States).

16. See id.; Insurance Information Institute, Facts and Statistics: Catastrophes: The Ten Most Costly Hurricanes in the United States, available at www.iii.org/media/facts/statsbyissue/catastrophes (last visited June 30, 2004) (listing Hurricane Andrew on August 23, 1992, which cost $20.9 billion, as the most costly hurricane in the United States and the second most costly insured loss in the world); Chris Isidore, Charley Could Pack Dollar Punch, CNNMoney, at http://money.cnn.com/2004/08/13/news/economy/hurricane_charley/index.htm (last visited Aug. 17, 2004) (estimating that Hurricane Charley which hit Southwest Florida on Friday, August 13, 2004, will be one of the most expensive storm in U.S. history with insured losses in the $10 billion range); Tom Herman, Ask Dow Jones, The San Diego Union-Trib., Aug. 22, 2004, at H7 (reporting that the Insurance Information Institute estimates that insurers are likely to deliver $7.4 billion to people whose homes, businesses and property were damaged by Hurricane Charley); Ivan's Stormy Trek Floods Southeast, CNN.com, at http://www.cnn.com/2004/WEATHER/09/16/hurricane.ivan/index.html (last visited Feb. 12, 2005) (recounting that in September, 2004, Hurricane Ivan, caused estimated insured losses from about $4 billion to $10 billion); Eqecat Estimates of Insured Losses from Hurricane Frances, at http://www.eqecat.com/documents/eqeca+sunday/9.5.04.pdf (last visited Sept. 21, 2004) (estimating that insured losses in September 2004 from Hurricane Frances in Florida and nearby states could range from $3 billion to $6 billion, but that the total loss estimate is likely to exceed $10 billion).

17. Terrorism accounted for 12.4% of the aggregate inflation-adjusted catastrophic losses in the United States. Insurance Information Institute, Facts and Statistics: Catastrophes: Inflation-Adjusted U.S. Catastrophe Losses by Category, at http://www.iii.org/media/facts/statsbyissue/catastrophes (last visited June 30, 2004).

18. See World Disasters Report 2002, supra note, at 173, 185 (Table 4) (noting that the total amount of estimated damages inflicted by disasters during 2001 was $24.4 billion – the decade's lowest and well below the annual average of $69 billion). Each week, direct costs of disasters worldwide "amount to well over a billion dollars." Id. at 37. Earthquakes, floods and windstorms have proven to be very expensive disasters. Id. at 173; see also National Climatic Data Center, Billion Dollar U.S. Weather Disasters 1980-2003 (Feb. 3, 2004) at http://www.ncdc.noaa.gov/oa/reports/billionz.html (last visited June 16, 2003) (reporting that the U.S. has suffered 58 weather-related disasters over the past 24 years in which overall damage was equal to or greater than $1billion and totaled nearly $350 billion); see also Insurance Information Institute, Facts and Statistics: Catastrophes: The Ten Most Costly World Insurance Losses, at http://www.iii.org/media/facts/statsbyissue/catastrophes (last visited June 30, 2004) (setting forth the ten most catastrophic losses in the world including September 11, 2001, costing $21 billion in insured losses, Hurricane Andrew, costing $20.9 billion, and the Northridge earthquake, costing $17.3 billion as the top three most costly disasters). The Federal Emergency Management Agency (FEMA) has listings of the federally declared disasters, emergency declarations and fire management assistance declarations beginning in 1953 through 2003 on its informative website. Federal Emergency Management Agency 2003 Federal Disasters Declarations, at http://www.fema.gov/news/disasters.fema?year=2003 (last visited June 4, 2003). Over this period, there were 1,504 major disasters declared with an average annual number of major disaster declarations of thirty. In 2003, FEMA reported fifty-six federally declared disasters ranging from a winter storm in Alaska to flooding in Florida to a tornado in New York and a hurricane in Texas. See Federal Emergency Management Agency: Disaster Federal Register Notices, at http://www.fema.gov/news/disasters.fema?year=2003 (last visited June 5, 2004). In addition, there were forty-six fire management assistance declarations and nineteen

catastrophic physical damage and loss.[19] While disasters can be earth shattering, they are commonplace, striking average citizens[20] worldwide almost twice a day.[21] In the United States, catastrophic disasters causing at least $25 million in direct damages occur almost twice a month.[22]

The challenges faced by victims of disasters are pervasive and overwhelming.[23] One of the many challenges is trying to comprehend and

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emergency declarations including the loss of the space shuttle, Columbia, on February 1 and the power outages in Michigan, New Jersey and Ohio on September 23. Id.

19. See Federal Emergency Management Agency, A Nation Remembers, A Nation Recovers, Responding to September 11, 2001, One Year Later (Sept. 2002); U.S. Small Business Administration, Business Assistance Guide, for the September 11th tragedy in the greater New York Area; Insurance Information Institute, Facts and Statistics: Catastrophes: September 11, 2001 World Trade Center Losses, at http://www.iii.org/media/facts/statsbyissue/catastrophes (last visited June 30, 2004) (recounting the catastrophic disaster on September 11, 2001, and enumerating the estimated total insured loss to be about $40 billion with property damage alone at $20.3 billion).

20. "Hazards are an unavoidable part of life. Each day, every one of us faces some degree of personal risk from hazards of one kind or another. The hazards we face are very diverse. They arise from our society (for example, conflict, terrorism, civil strife) and technology (industrial and transport accidents), as well as from the natural environment (such as floods, windstorms, droughts, earthquakes) and from threats to public health." World Disaster Report 2002, supra note 9, at 9.

21. See id. at 171, 185 (Table 1) (determining that the total number of disasters worldwide in 2001 was 712 (127 in the Americas), which was lower than the 759 disasters worldwide in 2000 (144 in the Americas), but was the second highest total of the decade with increases in weather-related disasters); FEMA, supra note 9 (stating that it is a myth to believe that a disaster will never happen to me and that every state in the U.S. is at risk for man-made disasters and for some natural disaster).

22. Insurance Information Institute, Facts and Statistics: Catastrophes: Insured Losses for U.S. Catastrophes 1994-2003, at http://www.iii.org/media/facts/statsbyissue/catastrophes/content.print (last visited July 3, 2004) (setting forth the number and dollar amounts of catastrophic insured losses from 1994 through 2003).

23. See for example World Disaster Report 2002, supra note 9, at 34 (natural disasters pose "undoubtedly massive" threats to human society); Jeanette Steele, San Diego County Firestorms Aftermath: Sadness, Frustration, Despair Creep In for Victims, Experts say Those Feelings are Normal, The San Diego Union-Trib., Feb. 15, 2004, at B1 (recounting that fire victims facing the Herculean task of restarting their lives may feel so depressed that they find it difficult to get out of bed in the morning or erupt in angry outbursts); San Diego County Firestorms Aftermath: Information You Can Use, The San Diego Union-Trib., Nov. 2, 2003, at A13 (describing a multitude of information for victims of the fires ranging from how to receive mail to avoiding fire-related scams); Michael Burge, Community Solutions: San Diego County Firestorms Aftermath: Neighbors Answer the Call to Mobilize moe than 100 for Valley Center Fire Recovery, The San Diego Union-Trib., Dec. 14, 2003, at A1 (describing five community outreach efforts to assist in myriad of fire victims needs from housing to clean-up to transportation to emotional support); Jane Clifford, San Diego Firestorms Aftermath: Building a Future, one in an occasional series, Brown Family, Taking Stock The San Diego Union-Trib. , Feb. 7, 2004, at E1 (explaining the tedious task of applying for insurance reimbursements including listing all household items up to and including toothpicks); Jeanette Steele, San Diego County Firestorms Aftermath: Insurance Shortfall, The San Diego Union-Trib., Mar. 21, 2004, at B1 (describing that because of significant insurance shortfalls many fire victims will need second mortgages or drain

manage the tax consequences of a disaster.[24] This Article describes the assortment of disaster relief and the federal income tax issues experienced by disaster victims.[25]

As a framework for this analysis, the Article will illustrate the various tax issues for a hypothetical family named the Bells, who like the Bellantes, lost everything in the 2003 Southern California wildfires.[26] Part II describes the

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their savings accounts to rebuild); Jeanette Steele, San Diego County Firestorms Aftermath: Owner Fears for Quality of Life, Ranch, The San Diego Union-Trib. , Mar. 21, 2004, at B4 (describing the challenges of inadequate insurance coverage); Jeanette Steele, San Diego County Firestorms Aftermath: Agent Told Scripps Ranch Man He Had Enough Home Insurance, The San Diego Union-Trib., Mar. 21, 2004, at B4 (describing $223,362 shortfall to rebuild home that victim believed was adequately insured); Nancy McCarthy, Attorneys and Judges Were Victims, Too, California Bar Journal, Dec. 2003, at 1, 14 (explaining the devastation fire victims experienced to their homes and businesses including how a "fireproof" box where important documents were stored melted); Anne Krueger, San Diego County Firestorms Aftermath: San Diego County Fair Exhibit An Act of Healing for Fire Victims, The San Diego Union-Trib., June 20, 2004, at B6 (quoting Caitlin Finch, a student who lost her family home in the wildfires, "Infinity is the number of times a day I feel like screaming. The number of times I have to fight back tears. The number of people who want to help and do, but then stroll back to the comfort of their somewhere. They don't truly know how it feels to be nowhere. And sometimes I wish I were them.").

24. See for example Dept. of the Treasury, Internal Revenue Service, 2003 Disaster Losses Kit for Individuals, Pub. 2194, at www.irs.gov (last visited June 17, 2004) (explaining in almost 100 pages tax relief for individual disaster victims). A similar kit exists for businesses. See Dept. of the Treasury, Internal Revenue Service, 2003 Disaster Losses Kit for Businesses, Pub. 2194B, at www.irs.gov (last visited June 17, 2004) (explaining tax disaster relief for business victims). Experts in taxation note that the delay in getting adequate disaster relief legislation enacted is indicative "of the complexity and cost of the tax issues involved." Annette Nellen, Disaster Relief Provisions: Changes to § 1033 and the Problems That Remain, 22 J. Real Est. Tax'n 158, 158; see Tom Herman, Ask Dow Jones, The San Diego Union-Trib., Aug. 22, 2004, at H7 (commenting that while taxes are probably "the furthest thing from their minds" Hurricane Charley disaster victims in Florida may benefit from a fresh look at available tax breaks).

25. In addition to federal income tax issues disaster victims may face state and local income and property tax issues. Many states incorporate federal income tax provisions including income tax disaster relief into their state statutes. Therefore, the coverage of federal disaster tax relief should be very informative for understanding similar state provisions. In addition, to income tax many states assess annual property taxes, which are ad valorem taxes based upon the value of the property. When a disaster damages or destroys property, many states have procedures for having the assessed value reduced, thereby reducing the owner's property taxes. See Annette Nellen, Disaster Relief Provisions: Changes to § 1033 and the Problems that Remain, 22 J. Real Est. Tax'n 158, 166-67 (1995). In addition, states may have limited provisions allowing replacement property to retain the same assessed value as the destroyed property despite the replacement property's higher fair market value on the date of the replacement. Id.; see Cal. Rev. & Tax Code § 69, 69.3 (2003). Disaster victims and their advisors should explore and maximize any state and local disaster relief tax provisions. This Article will address only federal income tax matters.

26. The Southern California wildfires provide an excellent framework for this analysis for several reasons. First, fire is a common disaster. According to the National Interagency Fire Center, "an average of 97,000 wildfires have burned nearly 5 million

many types of disaster relief for individuals and households including grants and loans from government agencies, reimbursements from private insurance providers, assistance from charitable and other non-profit organizations and gifts from family, friends and strangers. Part III discusses the tax consequences of these relief payments and various other tax provisions that provide relief for unreimbursed losses and reinvested gains.

The tax provisions presented include the tax treatment of reimbursements for additional living expenses and lost income and disaster loans. In addition, the Article presents the tax relief available for gains realized as a result of the disaster and tax benefits for casualty and net operating losses. Next, the Article describes the tax consequences of interest expense resulting from disaster relief loans and from existing loans on property that has been damaged or destroyed by the disaster. Finally, the Article imparts several administrative provisions that assist disaster relief victims with tax filing and payment deadlines and the challenges of restoring current and historic tax records. Part IV provides a summary and conclusion for the Article.

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acres annually each year in the past decade." See Michael D. Brown, Under Secretary Emergency Preparedness and Response, The California Fires Coordination Group A Report to the Secretary of Homeland Security (Feb. 13, 2004), at www.fema.gov/txt/library/draft_cfcg_report_0204.txt at 5 (last visited June 17, 2004) [hereinafter California Fires Report] (setting forth wildfire activity in the United States from 1994-2003). Moreover, wildfires are a continuing threat to wildland-urban communities. Id. at 5, 9 (stating that wildfires are a significant risk to more than 7.2 million California homes and that more than 190 million acres of Federal forest and rangelands, an area twice the size of California, are at risk for catastrophic wildfires); see Micah Morrison, Danger: Flames Ahead!, Parade (June 27, 2004) at 4-5 (stating that the dangers of catastrophic wildfires are growing across American and that they appear to be the wave of the future citing a thirteen-fold increase in catastrophic fires over the last two decades); Dar A. Roberts, The Fire Storm of 2003, 34 Coast Lines 38 (Winter 2004) (discussing the continuing threat of wildfires in Southern California). Second, the timing of these fires is appropriate because they are close enough in time to allow us to apply current law while still providing the opportunity to review post-disaster statistics and analysis. The California Fires Coordination Group has issued its extensive report on the fires providing qualitative and quantitative information on the relief provided during this historic disaster. California Fires Report, at www.fema.gov/txt/library/draft_cfcg_report_0204.txt at 50. Third, the 2003 California wildfires were among the largest fires in American history involving a unique level of coordination and magnitude of response. Id. at 50; Insurance Information Institute, Facts and Statistics: Catastrophes, at www.iii.org/media/facts/statsbyissue/catastrophes (last visited June 30, 2004) (listing the California 2003 wildfires as the eighth most costly catastrophe in the United States). Fourth, the documentation and analysis of the California wildfires is extensive and comprehensively reported on February 13, 2004 by the Washington D.C.-based California Fires Coordination Group headed by the Under Secretary for Emergency Preparedness and Response in the recently repositioned Federal Emergency Management Agency now part of the Department of Homeland Security. Id. Fifth, the Southern California wildfires are similar to many other disasters, including terrorism, that without discretion destroy personal and business use property and leave taxpayers homeless and stripped of all belongings and subject to a variety of different tax provisions.

II. ANATOMY OF A DISASTER: SOURCES OF RELIEF

A. Introduction: Southern California Wildfires of 2003

Eventually, the wildfire, named the Cedar Fire, raced away from the Bellantes' scorched property in its relentless pursuit of fuel.[27] The Bellantes, traumatized and weary, reunited with a neighbor who drove them to nearby Stelzer Park.[28] In the safety of the neighborhood park, paramedics attended to their burns and the long, torturous healing process began.[29] By the close of this life-altering day, October 26, 2003, eleven people had died, 500 homes were destroyed, and 30,000 more homes and thousands more people were being threatened from wildfires jeopardizing more than 200,000 acres.[30]

The Southern California wildfires in late October through early November of 2003 rank among the largest disasters in California's history and the costliest fires in American history.[31] In all, California suffered more than 750,000 scorched acres, over 15,000 damaged structures including 3,631 destroyed homes and many businesses, 217 injured people and 24 deaths.[32] Structural losses have been estimated between one and four billion dollars.[33] In response to California Governor Gray Davis' request President George W. Bush declared the California wildfires a major disaster on October 27, 2003 setting in motion an array of federal programs to assist individuals, like the Bellantes, in their recovery efforts.[34]

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27. The Cedar Fire was the largest, costliest and most destructive of the California 2003 wildfires. California Fires Report, supra note 26, at 15. This fire, which began in the early hours of October 26, 2003, grew to 115,000 acres within two days, and by the time it was contained on November 5, 2003, had scorched 273,246 acres, destroyed 2,200 homes and 22 businesses and caused 113 injuries and 14 deaths. Id.

28. See Clifford, supra note 1, at E1 (describing the Bellante family's narrow escape from death in the Cedar Fire).

29. Id. (Lori Bellante spent twelve days at UCSD's Burn Center for the severe burns on her arm).

30. See California Fires Report, supra note 26, at 18-21 (describing the chronology of the federal response to the 2003 California wildfires).

31. See id. at 4, 21 (detailing the historic losses of the 2003 California wildfires); Insurance Information Institute, Facts and Statistics: Catastrophes, at www.iii.org/media/facts/statsbyissue/catastrophes (last visited June 30, 2004) (listing the California 2003 wildfires as the eighth most costly catastrophe in the United States and the second most costly wildfire in the United States since 1970).

32. See California Fires Report, supra note 26, at 12, 21; Dar A. Roberts, The Fire Storm of 2003, 34 Coast Lines 38 (Winter 2004) (professing about the tragic, but not surprising losses from the 2003 Southern California wildfires).

33. Id. (reporting the costs of the fire including fire fighting costs estimated at hundreds of millions of dollars). See also California Fires Report, supra note 26, at 21 (estimating insured losses between $1.7 - $3.5 billion).

34. Id. at 4, 17-21 (elaborating the recovery efforts set in motion on October 27, 2003 when President George W. Bush, within hours of California Governor Gray Davis's request, declared the California wildfires a major disaster). Section 401 of the Stafford Act requires that "All requests for a declaration by the President that a major disaster exists shall be made by the Governor of the affected State." see 42 U.S.C. § 5170; 44 C.F.R. § 206.36(a). The Governor's request is made through the regional FEMA/EPR office after a preliminary damage assessment. Depart. of Homeland

B. Federal Emergency Management Agency (FEMA): Response and Recovery

The Department of Homeland Security's FEMA[35] is charged with, among other responsibilities, delivering aid to victims of major disasters declared by the President.[36] In 1988, Congress enacted the Robert T. Stafford Disaster Relief and Emergency Assistance Act[37] to provide support for State and local governments and their citizens when disasters overwhelm them and their resources.[38] The Stafford Act, as amended, establishes a process for requesting and obtaining a major disaster declaration by the President,[39] defines the type and scope of assistance available from the federal government and sets the conditions for obtaining assistance.[40] FEMA, now part of the Emergency Preparedness and Response Directorate of the Department of Homeland Security, is also charged with coordinating the federal government's response with State, local, and tribal governments and private and faith-based voluntary organizations.[41]

Security, Emergency Preparedness and Response Directorate, A Guide to the Disaster Declaration Process and Federal Disaster Assistance. The Governor must execute the State's emergency response plan as part of the request for federal assistance. Id. FEMA Brochure, supra note (detailing the federal disaster declaration process).

35. FEMA was an independent government agency until it became part of the new Department of Homeland Security in March 2003, FEMA, FEMA History, at www.fema.gov/about/history.shtm (Last visited June 22,2004) (tracing detailed history of FEMA beginning in 1803 until its current multi-faceted operation).

36. The Stafford Act gives the president the authority to direct "any Federal agency, with or without reimbursement, to utilize its authorities and [its] resources . . . in support of State and local assistance efforts." 42 U.S.C. § 5170a(1) (2004). Additionally, the president has the authority to coordinate all disaster relief assistance and provide or direct any federal agencies to provide certain assistance essential to meeting immediate threats to life and property resulting from a major disaster. 42 U.S.C. § 5170a, b; see also Sandra Leon & Sandy Lubin, FEMA: Federal Disaster Relief, 17 GPSolo 26, 27 (July/Aug. 2000) (describing the FEMA's charge for disaster relief); David G. Tucker & Alfred O. Bragg, III, Florida's Law of Storms: Emergency Management, Local Government, and the Police Power, 30 Stetson L. Rev. 837, 861-65 (Winter 2001) (describing FEMA and the various powers and responsibilities it has under the Stafford Act).

37. Pub. L. No. 93-288, 88 Stat. 143, (as amended, at 42 U.S.C. §§ 5121-5195 (1994)) the Stafford Act. Congress amended the Stafford Act, and President Clinton signed those amendments into law on October 30, 2000. Disaster Mitigation Act of 2000, Pub. L. No. 106-390, 114 Stat. 1552 (2000).

38. 44 C.F.R. § 206.35-208 (2004); see California Fires Report, supra note 26, at 8 (describing the declaration process in the case of the 2003 California wildfires).

39. 42 U.S.C. § 5170; 44 C.F.R. § 206.36(a); see Tucker & Bragg, supra note 36, at 862-63 (describing the process the Stafford Act and regulations provide for the president's declaration of a major disaster including one regulation § 206.48(a)(1) that suggests that the threshold amount of damage the state must meet or exceed for a residential declaration is one dollar per person in the state's population); Leon & Lubin, supra note 36, at 28 (setting forth the disaster or emergency declaration process).

40. 42 U.S.C. § 5174 (2004); see Tucker & Bragg, supra note 36, at 864-65 (describing the scope of the federal government's assistance available in a Presidentially declared major disaster); Leon & Lubin, supra note 36, at 28-29 (enumerating the recovery process and disaster aid programs for individuals and others).

41. 42 U.S.C. § 5170a; see Tucker & Bragg, supra note 36, at 863-64 (describing the federal government's response to a Presidentially declared major disaster); Leon & Lubin, supra note 36, at 27 (describing FEMA's role as coordinator

1. The Registration and Information Gathering Process

Immediately after the president declares a major disaster, FEMA employees travel to the disaster site "to set up a field office to coordinate the recovery effort."[42] "FEMA also opens recovery centers in or near the community affected by the disaster."[43] Disaster victims visit the centers to obtain information about the recovery process.[44] In addition, FEMA's national teleregistration centers are activated and toll free numbers are broadcast to allow affected residents and business owners to register for assistance and receive referrals to other aid providers.[45]

Every qualifying disaster victim[46] must register for assistance within a limited period of time[47] to establish eligibility for relief.[48] FEMA's specially trained employees register disaster victims with information provided over the telephone including the applicant's name, date of birth, Social Security number, home address, mailing address, telephone number, insurance information and

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of federal assistance); California Fires Report, supra note 26, at 18-19 (explaining FEMA's Federal Response Plan as a signed agreement among twenty-seven federal departments and agencies, including the American Red Cross, as "the mechanism for coordinating joint delivery of Federal assistance and resources to augment efforts of State and local governments overwhelmed by a major disaster or emergency through a series of agency-tasked Emergency Support Functions").

42. Leon & Lubin, supra note 36, at 28.

43. Id.

44. Id.

45. Id.; California Fires Report, supra note 26, at 28 (recounting the delivery of aid in the California wildfires of 2003, which stretched over 1,100 square miles and touched diverse and numerous communities).

46. "Only disaster victims who are U.S. citizens, non-citizen nationals (those born in an outlying U.S. possession, such as American Samoa), and qualified aliens are eligible to receive federal public benefits (i.e., grants and loans) from FEMA. This requirement does not apply to short-term, non-cash, in-kind emergency relief such as search and rescue, emergency medical care, emergency shelter, crisis counseling, and legal services." Leon & Lubin, supra note 36, at 28.

47. 44 C.F.R. § 206.112 (2204) (setting forth sixty-day standard period of registration, which may be extended and that late registrations with appropriate filings will be accepted for an additional sixty day period); see FEMA California, Recovery Times 1 at www.fema.gov/txt/rt/rt1498_sandiego.txt (Dec. 20, 2003) (encouraging disaster victims from the 2003 California wildfires to "[a]pply now to protect your ability to get help" and do not wait for insurance settlements before registering for assistance to cover uninsured or underinsured losses).

48. Dept. of Homeland Security, Emergency Preparedness and Response Directorate, Office of Legis. Affairs, A Guide to the Disaster Declaration Process and Federal Disaster Assistance (Mar. 2003), at www.fema.gov/rrr/dec_guid.shtm (last visited June 26, 2004) (setting forth the process and toll-free telephone registration number as 1-800-621-FEMA (or TYY 1-800-462-7585 for the hearing or speech impaired)); FEMA: The Disaster Assistance Process for Individuals, at www.fema.gov/about/process (last visited June 26, 2004) (setting forth general information about the registration process); FEMA California, Recovery Times 1 (Nov. 10, 2003) at www.fema.gov/txt/rt/rt1498.txt [hereafter Recovery Times (Nov. 10, 2003] (urging residents and business owners in disaster declared counties register with FEMA from 8 a.m. to 6 p.m. seven days a week, until further notice).

family gross income.[49] The application process takes approximately 15-20 minutes.[50] Applications with housing damage are referred to inspectors who schedule onsite visits to inspect the damaged property, verify ownership and occupancy and file a report with FEMA for consideration of assistance.[51]

When the registration period for the California wildfires of 2003 closed on January 9, 2004, FEMA had received 38,296 applications for assistance.[52] Because the declared disaster area stretched over 1,100 square miles,[53] the Disaster Field Office was established in Pasadena with satellite operating facilities in San Bernardino and San Diego.[54] FEMA staff worked with the California Governor's Office of Emergency Services and local authorities to set up as many as sixteen local area recovery centers in community centers and other convenient locations throughout the five-county disaster area.[55] These centers provided approximately 18,989 disaster victims with the opportunity to gather critical information and advice from representatives from federal relief organizations (such as FEMA, Small Business Administration, the Internal Revenue Service (IRS or Service) and the United States Department of Agriculture), private insurance providers and local volunteer agencies.[56] Through these resources individuals and households received disaster assistance.[57]

2. Federal Assistance to Individuals and Households

Federal assistance for individuals and households includes financial aid for damage to residences, businesses, and personal property and necessary

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49. Leon & Lubin, supra note 36, at 28; see also Recovery Times 1 (Nov. 10, 2003) supra note 48, at 2 (describing the disaster assistance registration process and related information).

50. Sean Holton and Jeff Kunerth, Getting Federal Help, Orlando Sentinel Trib., Feb. 25, 1988, at A12 (describing the federal assistance available for victims of tornadoes hitting Central Florida).

51. Recovery Times 1 (Nov. 10, 2003) supra note 48, at 2; Leon & Lubin, supra note 36, at 28; FEMA, About FEMA, The Disaster Assistance Process for Individuals, available at www.fema.gov/about/process (last visited June 26, 2004).

52. California Fires Report, supra note 26, at 28 (describing the details of the process and the aid delivered to fire victims); see also Vickie Chachere, Hundreds of Good Samaritans Help Florida Hurricane Victims, The San Diego Union-Trib., Aug. 22, 2004, at A-3 (reporting that FEMA had registered 77,000 households only one week after Hurricane Charley hit Florida).

53. California Fies Report, supra note 26, at 28 explaining the vastness of the disaster area.

54. Id. at 20, 26 (describing the activation of the Federal Response Plan as a result of the President's major disaster declaration).

55. Id. at 28 (detailing the delivery of aid to the victims of the fire). The five counties declared a major disaster by the president included Los Angeles, Riverside, San Bernadino, San Diego and Ventura. Id. at 12-16.

56. Id.

57. Leon & Lubin, supra note 36, at 28-30 (setting forth disaster relief assistance available to individuals and state and local governments). This Article will not discuss FEMA disaster relief provided to governmental agencies, because governmental agencies are not subject to tax and, therefore, there are generally no tax consequences of their receipt of relief.

expenses and serious needs that are not covered by insurance.[58] Only registered individuals and businesses that are located in an area declared a disaster by the president qualify for federal assistance.[59] This assistance is comprised of several components including low-interest loans, cash grants, and in-kind assistance.[60]

a. Small Business Administration (SBA) Disaster Loans

Most of the federal assistance for individual disaster victims is in the form of low-interest, federally subsidized loans for expenses not covered by state or local programs, or private insurance.[61] Any owner of damaged real property located in a Presidentially declared disaster area is eligible to apply for a loan to repair uninsured damage.[62] The government wants to encourage disaster victims to rebuild.[63] Therefore, government loans are not generally available to buyers of disaster property.[64] Small Business Administration (SBA) low-interest disaster loans of up to $200,000 are available to homeowners for real estate repairs, and additional loans of up to $40,000 are available to tenants and homeowners to replace personal property losses and other costs.[65]

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58. Id.; 44 C.F.R. § 206.11(h).

59. Leon & Lubin, supra note 36, at 28.

60. Recovery Times 1 (Nov. 10, 2003), supra note 48, at 3 (describing assistance available to disaster victims of the 2003 California wildfires).

61. See FEMA, Individual Assistance Programs, available at www.fema.gov/rrr/inassist.shtm (last visited June 26, 2004); Recovery Times (Nov. 10, 2003), supra note 48, at 2, 5 (setting forth answers to FAQs about disaster assistance and describing the availability of SBA loans); California Fires Report, supra note 26, at 53 (noting that eighty percent of the disaster relief in the California wildfires was from SBA in the form of low-interest loans); David W. Sar, Helping Hands: Aid for Natural Disaster Homeless vs. Aid for "Ordinary Homeless," 7 Stan. L. & Pol'Y Rev 129, 132 (Winter 1995-96) (describing the benefits of SBA loans in the disaster relief process); see also 15 U.S.C.A. § 636(b) (2004); 13 C.F.R. § 123 (2004), et seq.

62. See 13 C.F.R. § 123.3 (2004).

63. See Jeffrey A. Unger, Valuation of Real Estate Losses Arising From Natural Disasters: Opportunities for Coordination with FEMA Disaster Loss Verification, 25 J. Real Est. Tax'n 52, 58 (Fall 1997).

64. 13 C.F.R. § 123.101.

65. See 15 U.S.C. § 636(b); 13 C.F.R. § 123.61; Recovery Times 1 (Nov. 10, 2003), supra note 48, at 3 (detailing homeowner disaster loans). "Disasters are the only times the SBA may provide low-interest loans to homeowners, as well as small business owners." Leon & Lubin, supra note 36, at 29; see also FEMA, Recovery Times 3 (Dec.30, 2003) (answering FAQs on SBA loans including that the SBA can refinance an existing mortgage to include necessary funding for disaster repairs not covered by insurance). The SBA will increase the amount of any loan by up to twenty percent to protect from or mitigate damage from future similar disasters. 13 C.F.R. § § 123.7, 123.105(a)(4), 123.107 (2004). In addition to the costs of restoration and mitigation, SBA loans may cover personal expenses and professional fees. See Unger, surpa note 63, at 71. However, the SBA is prohibited from lending funds that represent compensation for the disaster victim's labor. 13 C.F.R. § 123.9(a) (2004).

The SBA also provides disaster loan assistance to businesses.[66] Businesses of any size in the disaster-declared and surrounding areas may borrow up to $1.5 million to repair or replace real estate, machinery and equipment, inventory and other business assets.[67] Small businesses may also qualify for working capital loans of up to $1.5 million to assist them with their cash flow needs through the disaster recovery period.[68]

The SBA works closely with FEMA to obtain the information it needs from disaster victims for its loan applications.[69] After registering with FEMA, a disaster SBA loan application is delivered to certain victims to gather more information about the applicant.[70] After a disaster victim completes her loan application, an SBA loss verifier inspects the property to document the damage.[71] The SBA details the amount necessary to repair various components of the damaged property in a Loss Verification Report.[72] While the loan approval process may take several weeks, the SBA processes these applications with special procedures and designated staff on an expedited basis.[73]

SBA personnel work closely with disaster victims during the entire rebuilding process, "which includes reviewing the completed application, performing financial analysis to determine creditworthiness, disbursing funds, and verifying the progress of repairs."[74] If approved, the loan agreement between the SBA and disaster victim will designate specific categories for use of the loan proceeds.[75] The SBA will only disburse disaster loan funds as the disaster victim submits her evidence of the designated repairs and the disbursed funds must be used for such designated purpose within sixty days.[76] If the disaster victim deviates her use of the loan proceeds from the specific categories without amending the loan agreement the disaster victim will be in default of the loan agreement and subject to civil penalties of up to fifty percent of the disbursed loan proceeds and potential criminal penalties.[77] Individuals

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66. See 15 U.S.C. § 636(b); 13 C.F.R. § 123.61; Recovery Times 1 (Nov. 10, 2003) supra note 48, at 3 (detailing business disaster loans).

67. Id.; California Fires Report, supra note 26, at 53 (describing this program as the Physical Damage Loan Program addressing physical damage to real estate and personal property including inventory); Dept. of Homeland Security, Emergency Preparedness and Response Directorate, A Guide to the Disaster Declaration Process and Federal Disaster Assistance 2 (updated Mar. 2003), at www.fema.gov/rrr/dec_guid.shtm (describing the assistance available for individuals).

68. Id.; Recovery Times 1 (Nov. 10, 2003) supra note 48 at 3, 5 (detailing the types of business disaster loans); California Fires Report, supra note 26, at 53 (describing this program as the Economic Injury Disaster Loan Program assisting in meeting basic operating expenses with working capital loans for disaster related business downturns).

69. Leon & Lubin, supra note 36, at 29 (describing the coordination of the SBA loan application process with the FEMA registration process to minimize duplication of services).

70. Id.

71. 13 C.F.R. § 123.100(b) (2004).

72. See Unger, supra note 63, at 55.

73. Leon & Lubin, supra note 36, at 29.

74. Unger, supra note 63, at 68.

75. 13 C.F.R. § 123.9(a).

76. Id.

77. 13 C.F.R. § 123.9(b).

and businesses that do not qualify for these loans may qualify for alternative assistance.[78]

After the ashes settled from the 2003 Southern California wildfires, FEMA had referred over 14,000 applicants to SBA (out of 38,296 registrants) resulting in 1,245 homeowner and nearly 200 business SBA loans totaling \$161,713,800.[79] Experts estimate that the final SBA disaster loan amount will range from \$175-200 million.[80] SBA loans represents the single largest source of federal disaster assistance "accounting for over 80 percent of non-insurance recovery resources" provided to these disaster victims.[81]

b. Individuals and Household Program (IHP)

Individuals who do not qualify for an adequate SBA loan[82] and have suffered losses not covered by insurance may receive cash grants for necessary expenses and serious needs including medical, dental, funeral, personal property, transportation, moving and storage and other government approved expenses.[83] This relief is provided by FEMA's IHP-Other Needs Assistance

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78. Id.; see Sar, supra note 61, at 132 (describing disaster relief provided by the SBA through low-interest loans); Recovery Times 1 (Nov. 10, 2003), supra note 48, at 2 (answering the question "What happens if I cannot afford a loan?"). In addition, the Department of Housing and Urban Development can provide increased limits for and a foreclosure moratorium on Federal Housing Administration (FHA)-insured loans. See California Fires Report, supra note 26, at 30 (describing a ninety day foreclosure moratorium on and increased limits of FHA-insured loans for disaster-affected properties). In addition, Fannie Mae, the nation's largest source of financing for home mortgages, has provided disaster relief to its borrowers. See Colleen Haggerty, Fannie Mae Announces Mortgage Relief for Wildfire Victims in Southern California (Oct. 27, 2003) at www.faniemae.com/newsreleases/cases/203/2812.shtm. The disaster relief may include temporary suspension or reduction of mortgage payments or even term modification. Id.

79. California Fires Report, supra note 26, at 31, 34, 53 (recounting how 100 SBA representatives were on site staffing information desks and attending public meetings to assist victims, while an additional 100 support staff were responding to the disaster in Sacramento).

80. Id.; FEMA, Six Months Later: More Than \$317 Million Approved For Southern California Wildfire Recovery (May 7, 2004) (setting forth the amount of SBA loans as reaching almost \$170 million six months after the deadly Southern California wildfires).

81. California Fires Report, supra note 26, at 31-32 (setting forth table depicting the combined FEMA/SBA aid).

82. 44 C.F.R. § 206.119 (2004) (requiring that applicant must apply to the SBA for relief and be declined or demonstrate that SBA assistance does not satisfy necessary expenses or serious needs arising out of the major disaster).

83. 42 U.S.C. § 5174(e) (2004) (setting forth parameters of financial assistance for other needs); 44 C.F.R. § 206.119 (describing the types of assistance available including clothing, schoolbooks, public transportation costs); Leon & Lubin, supra note 36, at 4; Dept. of Homeland Security, Emergency Preparedness and Response Directorate, A Guide to the Disaster Declaration Process and Federal Disaster Assistance (updated March 2003) at www.fema.gov/rrr/dec_guid.shtm.

(ONA) program and is funded seventy-five percent by FEMA and twenty-five percent by the relevant State.[84]

The IHP – Housing Assistance (HA) is intended to assure that people whose homes are damaged by a major disaster have a safe place to live.[85] When a major disaster is declared this program provides financial and in-kind assistance to people in the declared area whose property has been damaged or destroyed and whose losses are not covered by insurance.[86] Housing assistance includes financial or direct assistance for temporary housing (e.g., reimbursements for expenses related to hotels, motels or rental or temporary housing units when rental properties are not available) for up to eighteen months;[87] up to $5,100 for uninsured home repairs to return owner-occupied primary residences to a safe and sanitary living or functioning condition;[88] and under rare circumstances funds for home replacement and permanent housing construction.[89] Once approved, FEMA delivers housing assistance checks to disaster victims within seven to ten days of an onsite inspection.[90]

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84. 42 U.S.C. § 5174(g)(2) (describing the cost sharing between the federal and State governments); 44 C.F.R. § 206.110(i)(2); Leon & Lubin, supra note 36, at 4.

85. Dept. of Homeland Security, Emergency Preparedness and Response Directorate, A Guide to the Disaster Declaration Process and Federal Disaster Assistance (updated March 2003) at www.fema.gov/rrr/dec_guid.shtm.

86. 42 U.S.C. § 5174(a), (b) (setting forth when the President may provide housing assistance to disaster victims). A major disaster victim does not have to have applied for or have received a loan from the SBA to receive temporary housing, repair, replacement or permanent housing construction assistance. 42 U.S.C. § 5174(a)(2); (c)(2)(B). However, this assistance will not be provided if adequate insurance coverage is available. Dept. of Homeland Security, Emergency Preparedness and Response Directorate, A Guide to the Disaster Declaration Process and Federal Disaster Assistance (updated March 2003) at www.fema.gov/rrr/dec_guid.shtm.

87. 42 U.S.C. § 5174(c)(1) (setting forth the type of temporary housing assistance available); 44 C.F.R. § 206.117(b)(1) (detailing the aid to be made available to disaster victims); see also Sar, supra note 61, at 131-32 (explaining the temporary housing assistance available during recent disasters).

88. 42 U.S.C. § 5174(c)(2) (setting forth the type of disaster residence repair assistance the President may provide); 44 C.F.R. § 206.117(b)(2), (c) (detailing the type of repair assistance available up to $5,000 (as adjusted annually for inflation)); California Fires Report, supra note 26, at 30 (describing the repair assistance provided to victims of the California wildfires).

89. 42 U.S.C. § 5174(c)(3), (4) (setting forth the type of replacement and permanent housing construction financial assistance the President may provide to major disaster victims); 44 C.F.R. § 206.117(b)(3), (4) (describing the unique conditions under which this limited assistance ($10,000 adjusted for inflation for home replacement) is available); California Fires Report, supra note 26, at 30-31; Leon & Lubin, supra note 36, at 28-29; FEMA, Individual Assistance Programs, available at www.fema.gov/rrr/inassist.shtm (last visited Oct. 31, 2004).

90. Leon & Lubin, supra note 36, at 28 (describing the registration and recovery process); Sar, supra note 61, at 131 (reporting that after the 1994 San Fernando earthquake FEMA rushed housing assistance checks to uninsured victims of disasters in Los Angeles for two months of housing for renters ($2,200) and three months of housing for homeowners ($3,300)); Holton & Kunerth, supra note 50, at A12 (describing that federal assistance payments for Central Florida tornado victims should be available approximately one week after an on-site inspection).

Aggregate benefits provided by FEMA under the IHP are limited to $25,000 (indexed for inflation this benefit was increased to $25,600 in 2003) per individual or household.[91] In the 2003 California wildfires, FEMA provided over $32 million under these programs to disaster victims.[92] As of February 10, 2004, FEMA had issued 3,740 HA checks totaling approximately $8 million and 9,585 ONA checks aggregating approximately $24 million.[93] In addition, ninety families had been placed in temporary manufacturing housing while awaiting the repair of their damaged homes.[94] In addition to the immediate and sudden loss of housing and personal property, disasters disrupt the livelihoods of many, causing loss of employment and income as disasters force the closure of businesses.[95]

c. Disaster Unemployment Assistance (DUA)

The DUA program provides weekly unemployment benefits to individuals who are unemployed because of a Presidentially declared disaster and not covered by other unemployment compensation programs.[96] The benefits begin with the date of unemployment and can extend up to twenty-six weeks after the date of the President's declaration of the major disaster.[97] Qualifying individuals must register with their State employment services office.[98] As of January 26, 2004, FEMA approved 504 DUA claims totaling $203,240 of unemployment benefits for victims of the 2003 California wildfires.[99] In addition to unemployment cash benefits, the government may provide desperate disaster victims with in-kind benefits through its food stamp programs.[100]

91. 42 U.S.C. § 5174(h) (setting forth the maximum amount of federal assistance for individuals and households at $25,000 as adjusted annually for inflation); 44 C.F.R. § 206.110(b) (same); FEMA, Individual Assistance Programs, available at www.fema.gov/rrr/inassist.shtm (last visited Oct. 31, 2004); FEMA, Six Months Later: More Than $317 Million Approved For Southern California Wildfire Recovery (May 7, 2004) at www.fema.gov/news/newsrelease.fema?id=12175 (last visited Oct. 31, 2004) (noting that $25,600 is the maximum for FEMA benefits).

92. California Fires Report, supra note 26, at 30.

93. Id.

94. Id. at 31.

95. Id.

96. 42 U.S.C. § 5177(a) (setting forth authorization for the President to provide weekly unemployment compensation to disaster victims that would not otherwise be eligible); Dept. of Homeland Security, Emergency Preparedness and Response Directorate, A Guide to the Disaster Declaration Process and Federal Disaster Assistance (updated Oct. 22, 2004) at www.fema.gov/rrr/dec_guid.shtm (last visited Oct. 31, 2004); FEMA, Recovery Times 5 (Nov. 10, 2003) (educating victims about federal unemployment benefits for individuals who lost their job due to a Presidentially declared disaster).

97. 42 U.S.C. § 5177(a) (setting forth twenty-six week limitation); Dept. of Homeland Security, Emergency Preparedness and Response Directorate, A Guide to the Disaster Declaration Process and Federal Disaster Assistance (updated March 2003) at www.fema.gov/rrr/dec_guid.shtm (last visited Nov. 4, 2004).

98. Id.; see 42 U.S.C. § 5177(a) (directing the President to provide such assistance through agreements with States with adequate systems to administer such assistance).

99. California Fires Report, supra note 26, at 31.

100. 42 U.S.C. § 5179 (providing for federal disaster relief in the form of food stamps).

d. Emergency Food Stamp Program

The President is authorized to cause the United States Department of Agriculture (USDA) to distribute food stamps for low-income major disaster victims that are unable to purchase adequate amounts of nutritious food.[101] The USDA's Food and Nutrition Service administers an authorized Emergency Food Stamp Program, which provides expedited food stamp assistance to eligible applicants during a major disaster.[102] In the 2003 California wildfires, over 2,600 households received $853,939 in emergency food stamp assistance.[103] In addition, to emergency housing assistance, housing, wage, and food assistance the federal government provides much needed legal and crisis counseling to disaster victims.

e. Legal Services

FEMA, through an agreement with the American Bar Association's Young Lawyers Division, provides free legal assistance to low-income individuals who are unable to secure adequate legal services as a result of a major disaster.[104] The Legal Assistance typically includes assistance with insurance claims; replacement of important legal documents destroyed by the disaster; and counseling on landlord/tenant matters.[105]

f. Crisis Counseling Assistance and Training Program (CCP)

The CCP, authorized under the Stafford Act,[106] provides supplemental funding to States for short-term crisis counseling services for Presidentially declared disaster victims.[107] The program helps States respond immediately and for up to nine months for victims with mental health needs through screening,

101. 42 U.S.C. § 5179(a) (seeting forth authorization).

102. California Fires Report, supra note 26, at 29.

103. Id.

104. See 42 U.S.C. § 5182 (setting forth authorization for the assurance of adequate legal services for low-income households); Dept. of Homeland Security, Emergency Preparedness and Response Directorate, A Guide to the Disaster Declaration Process and Federal Disaster Assistance 2 (updated March 2003).

105. Id. 42 U.S.C. § 5182; Dent of Homeland Security, Emergency Preparedness and Response Directorate, A Guide to the Disaster Declaration Process and Federal Disaster Assistance 3 (updated March 2003) (advising that cases that will produce a fee are turned over to local lawyer referral services); Nancy McCarthy, When Disaster Strikes, Lawyers Help Out: Hundreds Offer Their Time and Advice – Free, California Bar Journal, Dec. 2003, at 1, 18 (recounting how one after another disaster victims were assisted by hundreds of volunteer lawyers activated through the ABA's Young Lawyer Division).

106. See 42 U.S.C. § 5183 (setting forth authorization for the President to provide professional counseling services to victims of major disasters to relieve mental health problems).

107. Dept. of Homeland Security, Emergency Preparedness and Response Directorate, A Guide to the Disaster Declaration Process and Federal Disaster Assistance 1 (updated March 2003); FEMA, Recovery Times 5 (Nov. 10, 2003) at www.fema.gov/pdf/rt/rt1448.pdf (educating victims about disaster-related stress).

diagnosis, counseling and community outreach and education.[108] Crisis counselors are often available at disaster recovery centers to help disaster victims immediately in managing their grief, stress or other mental health problems caused by or aggravated by the disaster or its aftermath.[109] FEMA approved $844,025 for State and local mental health agencies for the CCP in the 2003 California wildfires.[110]

C. Insurance Coverage

By far the most significant source of relief from the economic costs of a disaster in the United States is insurance.[111] Because real property is often acquired with debt and most lenders require insurance coverage to protect their secured interest, many real property owners have insurance coverage.[112] In addition to real property coverage, many automobile owners, tenants, home and business owners have insurance coverage for their personal property.[113] Additional insurance coverage includes reimbursements for additional living

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108. Dept. of Homeland Security, Emergency Preparedness and Response Directorate, A Guide to the Disaster Declaration Process and Federal Disaster Assistance 5-6 (updated March 2003).

109. Id.; FEMA, Individual Assistance Programs, available at www.fema.gov/rrr/inassist.shtm (last visited Oct. 31, 2004) (describing how to access confidential crisis counseling through FEMA's toll free Helpline number and disaster recovery centers).

110. California Fires Report, supra note 26, at 31.

111. See Internal Revenue Service, Casualties, Disasters, and Thefts, Pub. 547, at 5 (stating that the most common type of casualty reimbursement is an insurance payment); see also Insurance Information Institute, Facts and Statistics: Catastrophes, available at www.iii.org/media/facts/statsbyissue/catastrophes (last visited Nov. 4, 2004) (setting forth major U.S. catastrophes and the magnitude of the insured losses); World Disasters Report 2002, supra note 9, at 30 (noting that in developed countries insurance markets for natural hazards are well-established).

112. See Insurance Information Institute, Facts and Statistics: Homeowners Insurance, available at www.iii.org/media/facts/statsbyissue/homeowners/content.print (last visited Nov. 4, 2004) (stating that in 2001, 88% of all homeowners had insurance coverage); see also Insurance Information Institute, Publications: Settling Insurance Claims 13, available at www.iii.org (noting that "[a]s a condition of granting a mortgage, lenders usually require that they are named in the homeowners policy and that they are a party to any insurance payments related to the structure").

113. See id. (noting that in 2001, 48% of renters had insurance coverage for their personal property); Insurance Information Network of California, Consumer Issues: Insurance for Your House and Personal Possessions Item 10, available at www.iinc.org/cons_issues/home/insurance.html (noting that homeowners insurance policies typically include insurance coverage for the contents of one's home, which is generally 50% of the amount of insurance on the dwelling, but may be as high as 75%).

expenses[114] and lost rental[115] and business income[116] resulting from a covered loss.

In the 2003 California wildfires, the insured losses are estimated to reach more than $2 billion[117] or more than four times the aggregate amount of federal aid.[118] While these insured losses are catastrophic,[119] most of the fire victims who lost their homes were notably underinsured.[120] Nevertheless, the $2.04 billion of cash payouts from insurance companies to approximately

114. See Insurance Information Institute, Publications: Settling Insurance Claims 7, available at www.iii.org (describing additional living expense coverage as typically including extra food costs, increased housing costs, telephone or utility installation costs in a temporary residence, and extra transportation costs to and from work or school).

115. See Insurance Information Network of California, News & Issues: IINC Answers Questions Raised by Wildfires: Homeowners Coverage, available at www.iinc.org/news/home/Brushfire_Advisory2_2003.html (last visited Oct. 31, 2004) (answering the question of whether rental income is covered under a homeowners insurance policy by commenting that the policy covers the fair rental value of premises less any expenses that do not continue).

116. See Insurance Information Network of California, Consumer Issues: Catastrophe Planning for Businesses, available at www.iinc.org/cons_issues/business/catastrophe.html (last visited Oct. 31, 2004) (noting that businesses should make sure they have enough coverage for the indirect costs of a disaster including business disruption coverage, extra-expense insurance, as well as coverage for repairs and rebuilding).

117. See Dave Dasgupta, Insurance Services Office, Inc., Insurers to Pay California Policyholders $2.04 Billion for Wildfire Losses, Estimates ISO'S Property Claim Services Unit (Nov. 17, 2003) at www.iso.com/press_releases/2003/11_17_03.html (stating that insurers expect more than 19,000 claims from homeowners, businesses and vehicle owners from the wildfires); Dean Calbreath, No Satisfaction, The San Diego Union-Trib., May 16, 2004, at H1 (noting that by December 31, 2003 11,841 residential fire claims had been received by insurance carriers).

118. See California Fires Report, supra note 26, at 50, 54 (documenting the $483 million of federal assistance provided in the 2003 California wildfires).

119. See Insurance Information Institute, Facts and Statistics: Catastrophes, available at www.iii.org/media/facts/statsbyissue/catastrophes (last visited Nov. 4, 2004) (listing the California 2003 wildfires as the eighth most costly catastrophe in the United States).

120. See Jeannette Steele, San Diego County Firestorms Aftermath: Insurance Shortfall Burned-out Homeowners Grapple with Big Disparity Between the Estimates for Rebuilding and the Payouts, The San Diego Union-Trib., Mar. 21, 2004, at B1, B5 (reporting that of Southern California wildfires victims "[a]t least half of the homeowners are underinsured" and nationwide "64 percent of U.S. homes were undervalued by an average of 27 percent on homeowners insurance policies"); Jeanette Steele, San Diego County Firestorms Aftermath: Owner Fears for Quality of Life, Ranch, The San Diego Union-Trib., Mar. 21, 2004, at B4 (describing the challenges of inadequate insurance coverage); Jeanette Steele, San Diego County Firestorms Aftermath: Agent Told Scripps Ranch Man He Had Enough Home Insurance, The San Diego Union-Trib., Mar. 21, 2004, at B4 (describing $223,362 shortfall to rebuild home that victim believed was adequately insured).

19,000 Southern California fire victims will be the most significant source of disaster relief.[121]

D. Relief from Charitable and Other Non-Profit Organization

While insurance companies are the greatest source of economic relief from a disaster, private and faith-based non-profit organizations "are among the first to arrive and the last to leave communities touched by disasters."[122] Voluntary organizations such as the American Red Cross, Lutheran Disaster Response, Mennonite Disaster Services, Christian Aid Ministries, "create a coalition of caring that provides essential services to vulnerable populations such as low-income families, the elderly, and area residents."[123] "FEMA works with private and faith-based voluntary organizations by providing training and donations management support, as needed, and as a facilitator to assist voluntary agencies in forming Long-Term Recovery Committees (LTRCs)" with State and local governments.[124]

When State and local governments are alerted about a disaster, they contact the American Red Cross, State and local chapters of Volunteer Agencies Active in Disasters, and Church World Services (an interfaith group that contacts faith-based disaster aid groups) to assess, plan and coordinate their responses for the emerging needs of the disaster community.[125] "[V]oluntary organizations open and operate shelters, provide feeding services," and staff local area and disaster recovery centers to provide information to disaster victims.[126] Moreover, private and faith-based organizations assist local authorities and disaster victims throughout the recovery process, which may take as long as five years.[127]

As the California wildfires raged, approximately 10,871 people found shelter in 41 evacuation centers opened by the American Red Cross, local churches and other volunteer organizations.[128] More than 10,000 American Red

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121. See Dave Dasgupta, Insurance Services Office, Inc., Insurers to Pay California Policyholders $2.04 Billion for Wildfire Losses, Estimates ISO'S Property Claim Services Unit (Nov. 17, 2003) (stating that insurers expect more than 19,000 claims from homeowners, businesses and vehicle owners from the wildfires); Dean Calbreath, No Satisfaction, The San Diego Union-Trib., May 16, 2004, at H1 (noting that by December 31, 2003 11,841 residential fire claims had been received by insurance carriers).

122. California Fires Report, supra note 26, at 39 (summarizing the impact of voluntary agencies in the 2003 California wildfires).

123. Id. at 40-42.

124. Id. at 40.

125. Id.

126. Id.

127. Id.; see Jeanette Steele, Faithful Volunteers, The San Diego Union-Trib., June 20, 2004, at B1, B6 (describing how the faith-based Mennonite Disaster Service, Christian Aid Ministries and Christian Reform World Relief Committee of Grand Rapids, Michigan are coordinating hundreds of volunteers with the San Diego Firestorm Community Recovery Team to assist fire victims with free labor for home rebuilding).

128. See California Fires Report, supra note 26, at 41(noting that after the American Red Cross closed shelters it operated several service centers for assistance

Cross workers from around the country joined together with other volunteers to serve 374,000 meals and snacks through 49 fixed and 32 mobile feeding centers, deliver 6,057 comfort kits as well as provide childcare, health services and crisis counseling to thousands of overwhelmed victims.[129]

After the wildfires were under control on November 10, 2003, the American Red Cross closed all of the shelters and began to assist victims with the long process of recovery.[130] The American Baptist Men, Apostolic Christian Church, Southern Baptists, United Methodists Committee on Relief, and other volunteer groups worked with the government to establish clean-up procedures and assist in debris removal operations.[131] The Mennonite Disaster Service, Christian Aid Ministries and Christian Reform World Relief Committee continue to assist in the Southern California 2003 wildfire reconstruction effort by providing free labor to desperate fire victims with inadequate resources to rebuild.[132]

In addition, to national and faith-based volunteer assistance, communities joined together to provide relief for their disaster-victim neighbors.[133] Numerous community volunteer groups were formed immediately after the fires to help themselves and their neighbors cope with and recover from a disaster that changed their lives forever.[134] These community groups provided organized in-kind assistance including carpooling, temporary housing, repairs, clothing, running errands, debris removal, landslide control and

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of disaster victim and expects total costs for its organization for the California wildfire assistance to approach $10 million).

129. Id.; see also Vickie Chachere, Hundreds of Good Samaritans Help Florida Hurricane Victims, The San Diego Union-Trib., Aug. 22, 2004, at A-3 (reporting one week after Hurricane Charley hit Florida that the Red Cross had been preparing 125,000 meals a day and had housed 2,200 families in shelters).

130. See The San Diego Union-Trib., Dec. 14, 2003, at A1, A16-17 (describing five community volunteer groups and their efforts to help their neighbors through the wildfires and its aftermath.

131.Id. at 42.

132. Jeanette Steele, Faithful Volunteers, The San Diego Union-Trib., June 20, 2004, at B1, B6 (describing how the faith-based Mennonite Disaster Service, Christian Aid Ministries and Christian Reform World Relief Committee of Grand Rapids, Michigan are coordinating hundreds of volunteers with the San Diego Firestorm Community Recovery Team to assist fire victims with free labor for home rebuilding).

133. See also Vickie Chachere, Hundreds of Good Samaritans Help Florida Hurricane Victims, The San Diego Union-Trib., Aug. 22, 2004, at A-3 (commenting that it is "the unofficial aid stations that have become a life-line for many people" in the aftermath of Hurricane Charley in Florida and recounting how neighbors near and as far as California helped the disaster victims with basic needs such as water, ice, bread and peanut butter.

134. See for example Elizabeth Fitzsimons, Julian Volunteers Took Matters in Their Own Hands, The San Diego Union-Trib., Dec. 14, 2003, at A17 (quoting one neighbor who stated that "people's lives have been changed forever); Michael Burge, Community Solutions: San Diego County Firestorms Aftermath, Neighors Answer the Call Two Mobilize More Than 100 for Valley Center Fire Recovery, The San Diego Union-Trib., Dec. 14, 2003, at A1, A16 (describing how neighbors repaved a burned street and chopped down a tree to minimize the heartache for a father who lost his 16-year old daughter in a car accident escaping from the fire); Jeannette Steele, Assistance in Scripps Ranch Came Quickly, Efficiently, The San Diego Union-Trib., Dec. 14, 2003, at A17 (selecting the name Project Phoenix for their disaster relief group).

rebuilding.[135] In addition, to organized assistance, disaster victims may receive assistance spontaneously through gifts.

E. Gifts

When disaster strikes relatives, neighbors and strangers make informal direct gifts of cash and in-kind services and personal property including shelter, food, clothing and other basic necessities to disaster victims.[136] These gifts are usually given with love and affection and without any application, registration or restrictions. Out of the ashes from many different sources relief came pouring in to the victims of the California wildfires.

Soon after the ashes settled, disaster victims were faced daily with issues and decisions to begin their life-restoration process. A process that may last years and that undoubtedly will be heaving with challenges. Sorting through the tax consequences of the relief received and understanding the many tax relief provisions are some of the overwhelming hurdles facing disaster victims.[137]

III. TAX CONSEQUENCES OF RELIEF AND TAX RELIEF PROVISIONS

After receiving medical treatment, the Bells,[138] like the Bellantes, joined their fellow disaster victims exhausted, frightened and traumatized at one of the many emerging shelters.[139] At the shelter, the Bells were able to rest,

135. See Jeannette Steele, Assistance in Scripps Ranch Came Quickly, Efficiently, The San Diego Union-Trib., Dec. 14, 2003, at A17; Michael Burge, Poway Residents Go to Bat for Devastated Neighbors, The San Diego Union-Trib., Dec. 14, 2003, at A16; Anne Krueger, Crest Volunteer Group Came Together Within a Week, The San Diego Union-Trib., Dec. 14, 2003, at A16; Michael Burge, Two Mobilize More than 100 for Valley Center Fire Recovery, The San Diego Union-Trib., Dec. 14, 2003, at A1, A16 (quoting one neighbor who state that while they are not FEMA or the Red Cross they are filling the gaps for their neighbors); Elizabeth Fitzsimons, Julian Volunteers Took Matters in Their Own Hands, The San Diego Union-Trib., Dec. 14, 2003, at A17.

136. The Bells are a hypothetical couple that like the real life couple, the Bellante family, lost all of their material assets in the Southern California wildfires of 2003, including their home, business and all of their business and residential personal property. The Bells' story is fictitious, but based upon the real life hardship faced by millions of disaster victims every year. Any resemblance to actual persons is entirely coincidental.

137. See Leslie Berestein, Tax Relief for Homeowners Complicated, But Available, The San-Diego Union-Trib., Feb. 20, 2004, at C1, C5 (describing that while complex the tax laws may provide relief for disaster victims); John Eckhouse, Tax Considerations for East Bay Fire Victims, The San Francisco Chronicle, Dec. 9, 1991, at B2 (reporting that determining the tax consequences of the fire may be more daunting than rebuilding).

138. IRC §§ 1 et. seq.

139. California Fires Report, supra note 26, at 28 (describing the details of the process and the sixteen local recovery centers that delivered assistance to fire victims).

eat and receive basic necessities including crisis counseling.[140] Because President George W. Bush declared the California wildfires a major disaster, the Bells could register with FEMA by telephone for assistance.[141] Within a few days, an inspector would schedule an appointment to perform an onsite inspection.[142] Within a week to ten days after the inspection, the Bells would receive an SBA loan application and a check for any uninsured temporary housing and home repair needs.[143] If the Bells did not qualify for an SBA loan to cover any uninsured or underinsured necessary and serious personal expenses, they would receive a cash grant to cover these expenses.[144] The aggregate amount of federal assistance under these programs available in 2003 was $25,600.

In addition, if Mr. or Mrs. Bell became unemployed as a result of the disaster, either or both of them could apply for up to twenty-six weeks of unemployment assistance not otherwise available.[145] Moreover, the Bells would contact their insurance providers and begin the claim process for the insured damage to their home, car, personal belongings and rental and business losses.[146] As the Bells emerge from the shock of the wildfires and their catastrophic losses, they may visit one of the many disaster recovery centers to receive legal counseling including tax advice.[147] While the tax consequences of a disaster may not be among the most immediate issues facing a disaster victim, disaster tax issues are critical components of the recovery process.[148] This Part will describe these tax consequences for the millions of annual disaster victims like Frank and Jennifer Bell.

A. Exclusions from Gross Income

Under the Internal Revenue Code of 1986, as amended (the "Code"),[149] all amounts included in gross income generally increase federal taxable income

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140. See id. at 41 (describing and depicting relief facilities and resources provided by private and faith-based volunteer groups including counseling and comfort packages).

141. See id. at 8.

142. See Leon & Lubin, supra note 36, at 28.

143. See discussion regarding FEMA temporary housing assistance supra.

144. Id.

145. Id.

146. See FEMA California, Recovery Times 2 (Nov. 10, 2003) (describing how to file an insurance claim); Insurance Information Institute, How to Settle an Insurance Claim 2, at www.iii.org/media/publications (last visited Nov. 4, 2004) (detailing the insurance claims process and advising victims to contact their insurance company as soon as possible because of deadlines).

147. See California Fires Report, supra note 26, at 28 (describing that representatives from numerous agencies, including the IRS, were staffing centers to provide victims with "one-stop recovery shops") .

148. See Tom Herman, Ask Dow Jones, The San Diego Union-Trib., Aug. 22, 2004, at H-7 (taking a brief look at disaster tax relief on behalf of disaster victims from Hurricane Charley occurring on August 13, 2004).

149. IRC § 61(a)(3).

and, correspondingly, a taxpayer's federal income tax liability.[150] Gross income is very broadly defined and includes all income from whatever source derived unless specifically excluded under the Code.[151] Accordingly, all items of income received by an individual, including disaster victims, must be included in gross income unless specifically excluded.[152] Fortunately for disaster victims, the Code excludes certain types of disaster relief from gross income.

1. Disaster Loans

Gross income generally includes any accession to wealth.[153] An accession to wealth occurs if a taxpayer gains economically from a transaction.[154] Under the Haig-Simons definition of income, income for a specific period equals the sum of the taxpayer's increase in wealth plus any amount consumed for the period.[155] Loan proceeds that must someday be paid back to the lender do not constitute an accession to wealth.[156] A taxpayer's wealth does not increase because while she has an increase in her assets as a result of her receipt of loan proceeds she also has a corresponding increase in her liabilities as a result of her obligation to the lender. Thereby, while loan proceeds are not statutorily excluded from gross income,[157] loan proceeds are not income and thereby are excluded from the Code's broad definition of gross income.[158]

Most federal assistance for individual disaster victims is in the form of low interest, federally subsidized loans.[159] Fortunately, loan proceeds received

150. IRC § 63(b); see also James Edward Maule, Gross Income: Overview and Conceptual Aspects, 501-2nd Tax Management A-1, A-4 (providing an overview of the concept o f gross income and its relationship to taxable income and federal income tax liability). "Federal income tax liability is determined as a percentage of taxable income, which is derived from gross income." Id. at A-4 (citations omitted).

151. IRC § 61(a) (setting forth a nonexclusive list of relatively commonplace examples of gross income); see also Maule, supra note, at A-1 (describing the expansive scope of gross income).

152. See IRC §§ 101 through 139 (setting forth exclusions from gross income).

153. See Comm'r v. Glenshaw Glass Co., 348 U.S. 426, 431 (1920) (defining gross income as "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion").

154. See J. Sneed, The Configurations of Gross Income 14 (1967) (income occurs when there is a gain and gross income is income that is between gross receipts and taxable income).

155. See James Edward Maule, Gross Income: Overview and Conceptual Aspects, 501-2nd Tax Management A-8 (citing R. Haig, The Federal Income Tax (1920) and H. Simons, Personal Income Taxation (1938)).

156. See Dilks v. Comm'r, 15 B.T.A. 1294 (1929); Stayton, Jr. v Comm'r, 32 B.T.A. 940 (1935).

157. See IRC §§ 101 through 139A.

158. See IRC §§ 61(a), 71 through 90.

159. See FEMA, Individual Assistance Programs, available at www.fema.gov/rrr/inassist.shtm (last visited Nov. 4, 2004); FEMA, Recovery Times 2, 5 (Nov. 10, 2003) (setting forth answers to FAQs about disaster assistance and describing the availability of SBA loans); California Fires Report, supra note 26, at 53 (noting that eighty percent of the disaster relief in the California wildfires was from SBA in the form of low-interest loans).

by a disaster victim are not included in her gross income[160] and as a result is not included in her taxable income.[161] Therefore, a disaster victim's receipt and repayment of loan proceeds will not have any direct tax consequences.

In addition to the tax consequences of the receipt of the loan proceeds, the preferential rates and terms granted for disaster victims could themselves generate gross income.[162] Under the Code, certain borrowers enjoying below-market interest rate loans must recognize as gross income any forgone interest expense.[163] This provision could cause disaster victims to have to recognize as taxable income the amount of interest she is not paying because her below-market interest rate is below a minimum specified interest rate.[164] Fortunately for disaster victims any loans "subsidized by the Federal, State (including District of Columbia), or Municipal government (or any agency or instrumentality thereof), and which are made available under a program of general application to the public" are exempt from the requirement to include imputed interest in gross income.[165] In addition, other forms of disaster relief such as gifts are excluded from gross income under the Code.

2. Gifts: IRC Section 102

When disasters hit family members, friends, strangers and charities may make direct payments to disaster victims to help them get back on their feet.[166] Fortunately, for these disaster victims gross income does not include the value of property, including cash, acquired by gift.[167] Neither the Code nor the Treasury Regulations provide taxpayers with a definition of gift, but the Supreme Court has described one essential element of a gift as "detached and disinterested generosity, . . . out of affection, respect, admiration, charity or like impulses."[168] The transferor must intend that the transfer is a gift[169] without any strings or expectation for any returned consideration.[170] Accordingly, the gift exclusion does not include any amount transferred by or for an employer to, or for the benefit of, an employee.[171]

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160. See James J. Freeland, Daniel J. Lathrope, et al., Fundamentals of Federal Income Taxation 62-63 (14th ed. 2004)

161. IRC § 63.

162. See IRC § 7872 (imputing interest income for borrowers with below-market interest rate loans).

163. IRC § 7872(a)(1).

164. IRC § 7872(e)(2) (defining forgone interest).

165. Prop. Regs. § 1.7872-5T(b)(5).

166. See for example Vickie Chachere, Hundreds of Good Samaritans Help Florida Hurricane Victims, The San Diego Union-Trib., Aug. 22, 2004, at A-3.

167. IRC § 102(a).

168. See Commissioner v. Duberstein, 363 U.S. 278, 285 (1960).

169. Id. at 285-86 (stating that whether or not a transfer is a gift requires an inquiry into the transferor's intention in making the payment).

170. See RunyOn v. Comm'r, T.C. Memo 1984-623 (holding that payments were gifts because the transferors expected nothing in return); Veterans of Foreign Wars, Dept. of Mich. v. Commissioner, 89 T.C. 7, 42 (1987) (holding that payments in excess of fair market value were a gift because purchasers intended to provide the organization with more than the selling price as a gift).

171. IRC §102(c) (describing that transfers from employers may not be excluded from gross income unless the transfer qualifies as a de minimis fringe benefit under IRC § 74(c) or an employee achievement award under IRC § 132(c)); but see

However, transfers made by charities and private parties to disaster victims without any expectation of returned consideration will qualify for this exclusion from gross income. "[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."[172] Taxpayers that receive cash or real or personal property interests from any transferor out of love and affection can exclude them from gross income.[173]

Governmental relief in response to a disaster generally does not constitute a gift because the government does not have the requisite donative intent because it is obligated to provide disaster relief.[174] Accordingly, these payments are not excludible from gross income under the gift exclusion. Alternatively, disaster relief payments "made by governmental units under legislatively provided social benefit programs for the promotion of the general welfare (i.e., based on need)" are not includible in gross income under the "general welfare exclusion."[175] More recently, Congress incorporated this long-standing general exclusion into a specific exclusion under the Code. The new provision excludes from gross income all disaster relief provided by

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Priv. Ltr. Rul. 2003-07-084 (finding that hardship payments made to employees from public charity were excludible gifts because corporate-employer did not control the charity or its process for selecting recipients for relief).

172. Rev. Rul. 2003-12, 2003-3 I.R.B. 283; see Comm'r v. Duberstein, 363 U.S. 278, 285 (1960).

173. See Kavoosi v. Comm'r, T.C. Memo 1986-190 (holding that payments made to friend were excludable gifts because of his personal affection for his friend's parents); Mesinger v. Commissioner, T.C. Memo 1972-229 (holding that payments to writer were made out of personal affection and not because of an expected benefit).

174. Rev. Rul. 2003-12, 2003-3 I.R.B. 283.

175. Rev. Rul. 2003-12, "The Internal Revenue Service has concluded that payments made by governmental units under legislatively provided social benefits programs for the promotion of general welfare (i.e., based on need) is not includible in the gross income of the recipients of the payments. . . ." Id.; see Rev. Rul. 98-19, 1998-15 I.R.B. 5 (permitting exclusion of relocation payments authorized and funded by the government); Rev. Rul. 76-144, 1976-1 C.B. 17 (concluding that grants received under the Disaster Relief Act of 1974 by individuals unable to meet necessary expenses or serious needs as a result of a disaster are in the interest of general welfare and not includible in the recipients' gross income); Rev. Rul. 82-106, 1982-1 C.B. 16 (providing that payments by non-governmental entities cannot be considered payments for the general welfare and therefore may not qualify for exclusion from gross income under the general welfare exclusion); Chief Couns. Adv. 200114044 (finding that payments from FEMA for living expenses to uninsured or underinsured victims of Presidentially declared disasters are excluded from gross income under the "general welfare" exception of Code § 61); Chief Couns. Adv. 200114045 (same); Chief Couns. Adv. 200114046 (determining that FEMA payments for flood insurance premiums and claim preparation expenses are excluded from gross income); Priv. Ltr. Rul. 199918053 (finding that state government assistance payments for food and other necessities for disaster victims who could not afford to pay for necessities were excluded from gross income); Chief Couns. Adv. 200017040 (finding that payments made pursuant to state disaster relief program to assist individuals purchasing comparable housing outside of flood plain were excluded from gross income).

government and certain disaster relief provided by any transferor, including certain transfers from employers to employees.[176]

3. Disaster Relief Payments: IRC Section 139

In response to the tragic events of September 11th, Congress enacted the Victims of Terrorism Tax Relief Act of 2001,[177] which among other things, provides under Code Section 139 that gross income does not include any amount received by an individual as a "qualified disaster relief payment."[178] The definition of a "qualified disaster relief payment" is very comprehensive with narrow and well-reasoned exceptions.[179] Specifically, a qualified disaster relief payment includes "any amount paid to, or for the benefit of an individual to reimburse or pay reasonable and necessary personal, family, living, or funeral expenses incurred as a result of a qualified disaster."[180]

Notably, this definition is an expansion of the general welfare exclusion because it includes relief payments received by or for a disaster victim from any source, including employers.[181] Specifically included in the definition of "qualified disaster relief payment" are payments from any source "to reimburse or pay reasonable and necessary expenses incurred for the repair or rehabilitation of a personal residence or repair or replacement of its contents to the extent that the need for such repair, rehabilitation, or replacement is attributable to a qualified disaster."[182] A rented residence can qualify for this exclusion.[183] In addition, a "qualified disaster relief payment" includes any amount paid to or for the benefit of a disaster victim from "a Federal, State, or local government, or agency or instrumentality thereof, in connection with a qualified disaster in order to promote the general welfare."[184] Disaster victims are not required to keep records of actual expenses incurred, provided that the payments received can be expected to reasonably approximate the costs suffered as a result of the disaster.[185]

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176. IRC § 139(b)(1), (2) and (4); see also Rev. Rul. 2003-12, 2003-1 C.B. 283 (demonstrating that while certain disaster relief payments from employers to employees are accessions to wealth that cannot be excluded as a gift or under the "general welfare exception," they can be excluded under Code § 139).

177. Pub. L. No., 107-134, § 111, 115 Stat. 2427 (2002), (setting forth new Code § 139 effective for taxable years ending on or after September 11, 2001).

178. IRC §§ 139(a), 61(a), 63 (setting forth an exclusion from gross income and in turn taxable income any amount received as a "qualified disaster relief payment").

179. See IRC § 139(c), (e) (setting forth definition of qualified disaster).

180. IRC § 139(b)(1).

181. See Maule, supra note 150, at A-199.

182. IRC §139(b)(2).

183. Staff of the Joint Comm. on Taxation, Technical Explanation of the "Victims of Terrorism Tax Relief Act of 2001," as passed by the House and the Senate on Dec. 20, 2001, 16 (Comm. Print 2001).

184. IRC § 139(b)(4). Also included in the definition of "qualified disaster relief payment" is any payment to or for the benefit of an individual "by a person engaged in the furnishing or sale of transportation as a common carrier by reason of the death or personal physical injuries incurred as a result of a qualified disaster." IRC § 139(b)(3).

185. See Maule, supra note 150, at A-200.

Not surprisingly, tax-free treatment is denied for a double reimbursement or any payment of an expense that has already been reimbursed by insurance or otherwise.[186] Similarly, to the extent any payment is for expenses for which a taxpayer has enjoyed a tax deduction in a previous taxable year, the payment may not be excluded from gross income under the tax benefit doctrine.[187] Also not surprisingly, the exclusion does not apply to individuals who the Attorney General identifies as a participant or conspirator, or any representative of the foregoing, in a terroristic action.[188] Finally, any payments received replacing lost income, such as unemployment compensation[189] or lost business profits[190] must be included in gross income in the tax year received.[191]

A "qualified disaster" for this purpose is defined very broadly and includes "a disaster which results from a terroristic or military action,"[192] "a Presidentially declared disaster,"[193] "a disaster which results from an accident

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186. IRC § 139(b) (flush language).

187. See Rev. Rul. 74-74, 1974-1 C.B. 18 (denying exclusion from gross income for medical expense reimbursements received); Chief Couns. Adv. 200016019 (commenting that state grants for the repair of flood-damaged homes would be included in gross income to the extent that losses were deducted); see also Notice 2001-42, 2001 C.B. 70. I.R.B. (warning victims of the CERRO Grande Fire that payments that reimburse them for medical expenses must reduce any deduction to be taken for medical expenses).

188. IRC § 139(e).

189. See IRC § 85 (providing that unemployment compensation is specifically included in gross income).

190. If the payments are for the loss of the use of business property versus lost profits, then the payments may qualify as proceeds from an involuntary conversion eligible for deferral of recognition under IRC § 1033. See Rev. Rul. 86-12, 1986-1 C.B. 290 (discussing distinction between profit loss and loss of use and occupancy in the context of insurance proceeds); Regs. § 1.1033(a)-2(c)(8) (providing that proceeds for lost profits do not qualify as involuntary conversion proceeds and, therefore, must be included in ordinary income); see also Bruce N. Edwards, Involuntary Conversions, 568 Tax Mgmt. (BNA) A-56 through A-57 (discussing the tax treatment of insurance proceeds from a business interruption insurance policy).

191. See Maule, supra note 150, at A-200; Chief Couns. Adv. 200013030 (2000), (finding that state relief payments made to farmers, growers' associations, and fisherman that suffered business losses caused by a hurricane were not excluded from gross income because the payments were made to replace lost profits). Because the exclusion applies to reimbursements that are not attributable to wages, compensation or self-employment earnings, payments qualifying for exclusion from gross income are also excluded from self-employment and employment taxes. IRC § 139(d). Compensation for lost profits must be recognized in the tax year received or accruable, which may not correspond to the actual period of loss. See Cappel House Furnishings Co. v. United States, 244 F.2d 525 (6th Cir. 1957).

192. For this purpose, terroristic or military action is defined in § 692(c)(2) and means "any terroristic activity which a preponderance of the evidence indicates was directed against the United States or any of its allies, and any military action involving the Armed Forces of the United States and resulting from violence or aggression against the United States or any of its allies (or threat thereof). For purposes of the preceding sentence, the term military action does not include training exercises." IRC § 692(c)(2).

193. For this purpose, a Presidentially declared disaster is defined in §1033(h)(3) and "means any disaster which, with respect to the area in which the property is located, resulted in a subsequent determination by the President that such

involving a common carrier, or from any other event, which is determined by the Secretary to be of a catastrophic nature."[194] In addition, with respect to amounts received from the government, its agency or instrumentality, any disaster that is determined by the governmental authority to warrant assistance.[195] Accordingly, this expansive definition should exclude from a disaster victim's gross income any payments received from a governmental authority that is not attributable to lost wages or profits.

Prior to Congress' enactment of these specific gross income exclusions under Code Section 139, disaster relief payments made by governmental units under legislatively provided social benefit programs for the promotion of the general welfare (i.e., based on need) were not includible in the gross income under the "general welfare exclusion."[196] While Code Section 139 does not replace the "general welfare exclusion," it appears to embody all government payments made for disaster relief under the exclusion as well as providing exclusion for nongovernmental payments for certain types of disaster relief.[197] Code Section 139 is an expanded, yet explicit statutory version of the "general welfare exclusion" of disaster relief payments from gross income.[198]

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area warrants assistance by the Federal Government under the Disaster Relief and Emergency Assistance Act." IRC § 1033(h)(3).

194. IRC § 139(c) (defining what is a "qualified disaster").

195. IRC § 139(c)(4).

196. "The Internal Revenue Service has concluded that payments made by governmental units under legislatively provided social benefits programs for the promotion of general welfare (i.e., based on need) is not includible in the gross income of the recipients of the payments." Rev. Rul. 2003-12, 2003-1 C.B. 283; see Rev. Rul. 98-19, 1998-1 C.B. 840 (permitting exclusion of relocation payments authorized and funded by the government); Rev. Rul. 76-144, 1976-1 C.B. 17 (concluding that grants received under the Disaster Relief Act of 1974 by individuals unable to meet necessary expenses or serious needs as a result of a disaster are in the interest of general welfare and not includible in the recipients' gross income); Rev. Rul. 82-106, 1982-1 C.B. 16 (providing that payments by non-governmental entities cannot be considered payments for the general welfare and therefore may not qualify for exclusion from gross income under the general welfare exclusion); Chief Couns. Adv. 200114044 (2001) (finding that payments from FEMA for living expenses to uninsured or underinsured victims of Presidentially declared disasters are excluded from gross income under the "general welfare" exception of Code § 61); Chief Couns. Adv. 200114045 (2001) (same); Chief Couns. Adv. 200114046 (2001) (determining that FEMA payments for flood insurance premiums and claim preparation expenses are excluded from gross income); Chief Couns. Adv. 199918053 (1999) (finding that state government assistance payments for food and other necessities for disaster victims who could not afford to pay for necessities were excluded from gross income); Chief Couns. Adv. 200017040 (2000) (finding that payments made pursuant to state disaster relief program to assist individuals purchasing comparable housing outside of flood plain were excluded from gross income).

197. See Rev. Rul. 2003-12, 2003-1 C.B. 283. Moreover, as a result of the enactment of Code § 139 and the Joint Committee on Taxation Staff's comment that disaster victims will not have to account for their actual expenses as long as the payments can be reasonably expected to be commensurate with the expenses to be incurred, the Internal Revenue Service has stated that the same standard will apply for disaster relief under the general welfare exclusion. Id.

198. Id. (ruling that grants to employees from their employers' program to pay or reimburse certain reasonable and necessary medical, temporary housing, or transportation expenses resulting from a flood are not included in gross income under

While Code Section 139 is very broad in its coverage of disaster relief payments that are excluded from gross income, it specifically does not include payments received from insurance providers.[199] Many disaster victims who have insurance coverage will not receive government assistance because their insurance providers will reimburse their covered disaster related expenses. Fortunately for these disaster victims, the Code provides an exclusion from gross income for certain payments received from insurance providers.[200]

4. Insurance Payments for Excess Living Expenses: IRC Section 123

Code Section 123 generally provides that gross income does not include insurance payments received for excess living expenses incurred because a taxpayer cannot occupy her principal residence as a result of damage or destruction from a casualty.[201] The loss of use or occupancy must result from a fire, storm or other casualty or the government's denial of access to the property because of the threat or occurrence of a casualty.[202] Insurance reimbursements for excess living expenses incurred because of a condemnation not related to a casualty are not excluded from gross income under this narrowly drafted exclusion.[203]

In addition, the reimbursements must be for loss of use or occupancy of property that is the disaster victim's principal residence, which includes a house or apartment that is leased or owned outright.[204] Whether or not the property is the taxpayer's principal residence is a facts and circumstances analysis of the taxpayer's living arrangements.[205] This analysis is critical because insurance reimbursements attributable to increased expenses for the

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Code § 139 but not the "general welfare exclusion"). Prior to enactment of IRC § 139, there was no statutory exclusion for disaster relief payments and taxpayers had to rely on interpretations of the "general welfare" exception to gross income. See sources cited supra note 157; see also Rev. Rul. 57-102, 1957-1 C.B. 26 (setting forth that amounts received from a government's general welfare fund are excluded from gross income). In addition to providing for a specific statutory exception for general welfare payments, Code § 139 provides for exclusion from gross income of certain payments from common carrier businesses for death or personal injuries. IRC § 139(b)(3), (4).

199. IRC § 139(b) (flush language) (providing that payments are excluded from gross income to the extent not compensated by insurance).

200. See IRC § 123 (setting forth exclusion from gross income for insurance payments received for certain additional living expenses incurred due to a disaster).

201. IRC § 123(a). Prior to Congress' enactment of Code § 123 in 1969, insurance reimbursements for additional living expenses incurred because of the destruction of a taxpayer's residence due to a casualty were included in a taxpayer's gross income, taxable income and, therefore, subject to income tax. See McCabe v. Comm'r, 54 T.C. 1745 (1970) (holding that the McCabe's gross income included insurance proceeds they received due to the loss of occupancy of their principal residence due to a kitchen fire); Millsap v. Comm'r, 46 T.C. 751 (1966), acq., 1967-1 C.B. 2, aff'd, 387 F.2d 420 (6th Cir. 1968); Cornelius v. Comm'r, 56 T.C. 976, acq., 1977-2 C.B. 1, Rev. Rul. 59-360, 1959-2 C.B. 75, declared obsolete by Rev. Rul. 72-619, 1972-2 C.B. 650.

202. IRC § 123(a).

203. See Regs. § 1.123-1(a)(3).

204. Regs. § 1.123-1(c).

205. Id.

loss of use of any nonresidential portion or whole property are not excluded from gross income.[206] Moreover, the exclusion only applies to amounts that are specifically identified by the insurance company as being paid exclusively for excess residential living expenses.[207] Any unallocated lump-sum insurance payment must be allocated among the various insurance claims, including additional living expenses, but must be limited to the contractual amount of coverage.[208]

The exclusion from gross income only applies to reimbursements for increased living expenses resulting from the disaster for the taxpayer and members of her household for the period of loss of use or occupancy.[209] The period of loss of use or occupancy is limited to "the period of repair or replacement of the damaged principal residence or denial of access by governmental authority."[210] Excludible increased living expenses must be reasonable and necessary actual household expenses incurred to maintain the taxpayer's and her household's customary standard of living that are in excess of normal household expenses.[211] Generally, excludable actual living expenses include the cost for renting suitable temporary housing, meals at restaurants, which customarily would have been prepared in the residence, and other extraordinary utilities, transportation, and other expenses.[212]

A number of expenses specifically do not qualify for exclusion under Code Section 123. For example, insurance reimbursements for any normal, that is, not excess living expenses including mortgage payments on a damaged residence cannot be excluded from gross income.[213] The reasoning is that mortgage payments are contractual obligations that have "no causal relationship to the occurrence of the casualty" and cannot be included in the analysis as either normal or excess expenses.[214] A disaster victim must include insurance reimbursements for normal living expenses in gross income in the later of the tax year the disaster victim regains use of her residence, or the tax year of its receipt.[215] While this does not provide exclusion of these reimbursements from gross income, it may provide for a deferral of the recognition of the income.

The limitations for excludible insurance reimbursements from gross income are strict, but in practice they may have little application. Homeowner's

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206. See Regs. § 1.123-1(a)(3).

207. See Regs. § 1.123-1(a)(4)(i).

208. See Regs. § 1.123-1(a)(4)(ii), -1(a)(4)(iii).

209. IRC § 123(a), (b); Regs. § 1.123-1(a)(2).

210. Regs. § 1.123-1(b)(1), -1(a)(2).

211. Regs. § 1.123-1(a)(2). If the loss of use or occupancy results in a decrease in normal household expenses during the loss period, then such amount is not considered to have been incurred to the extent of the decrease for purposes of determining the excess expenses incurred. Regs. § 1.123-1(b)(3), -1(b)(4) (setting forth example where bus fares decreases by $20 because temporary housing is closer to work so the normal bus fare is equal to this decrease in expense or $20).

212. Regs. § 1.123-1(b).

213. See Regs. § 1.123-1(b)(2), -1(b)(4).

214. See Regs. § 1.123-1(b)(4) (Example (1)); see also Maule, supra note 150, at A-190 (setting forth application of the statute to hypothetical situation).

215. Internal Revenue Service, Casualties, Disasters, and Thefts, Pub. 547, at 5 (2004) (describing and providing an example of the timing of recognition of excess insurance reimbursements in gross income).

insurance coverage generally only reimburses a homeowner for additional living expenses, which is defined consistently with the exclusion provision.[216] Accordingly, most insurance reimbursements received for additional living expenses incurred as a result of a disaster will be excluded from gross income.

In comparison, homeowner's insurance coverage typically does include insurance coverage for lost rental income and reimbursements for damage to, real or personal property.[217] In addition, business insurance coverage usually provides relief for lost business profits and damage to real and personal property. Insurance reimbursements for lost rental and business income and damage to real or personal property are not excluded from gross income under this provision.[218] While disaster victims must include any lost rental and business income in gross income,[219] under certain situations the Code provides that any gain resulting from insurance reimbursements for damage to or destruction of real or personal property may be deferred and not included in gross income for the current tax year.[220] The applicable provision of the Code provides that under certain circumstances a disaster victim may defer recognition of any gain resulting from the involuntary conversion of property into cash (e.g., insurance proceeds).[221] Before the Article presents the relief provided under the Code for gain realized as a result of a disaster, the foregoing provisions will be applied to the Bells, our hypothetical disaster victims.

5. Application to the Bell Family, Hypothetical Disaster Victims

As the Bells and their surviving neighbors begin to emerge from the nightmare of the California wildfires, the Bells almost daily contemplate the magnitude of their losses; the assistance they have received during the first few months of their recovery and the insurance proceeds they hope and anticipate are forthcoming. The Bells lost everything, but their lives. The staggering extent of their losses include their family home and business, Wildcat Canyon Laundromat, and all contents, including all clothing (except the jeans and sweatshirts each threw on as they ran for their lives), household goods, furniture, and their business machinery and equipment and all their personal and business records.

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216. See Insurance Information Network of California, IINC Answers Questions Raised by Wildfires, at www.iinc.org/news/home/Brushfire_Advisory2_2003.html (last visited July 6, 2004) (answering the question regarding coverage for extra expenses incurred when a home is severely damaged and uninhabitable).

217. See id. (describing that homeowners insurance includes typically includes reimbursement for damage to real and personal property and "the fair rental value of premises less any expenses that do not continue while it is not fit to live in").

218. See Maule, supra note 150, at A-189.

219. Id. While reimbursements for lost income must be included in gross income, under certain circumstances farmers may defer recognition of the income until the taxable year after receipt. IRC § 451(d), (e) (providing that farmers may defer recognition of insurance proceeds for crop damage or sale proceeds from livestock sold on account of drought until the year after receipt if she can establish that the proceeds would not have arisen if not for the damage or drought).

220. See IRC § 1033.

221. Id.

Immediately after the fire destroyed their home, the Bells sought shelter in an American Red Cross facility receiving basic necessities, including food, beds, hygiene kits, clothing and crisis counseling. From the shelter, the Bells were able to register with FEMA and contact their insurance company to begin their claim process. Soon after these contacts, site inspectors visited the rubble that was once their home and business. After inspectors combed the property, with the assistance of their community association the Bells began to clear the debris from their property.[222]

Soon after initiating the disaster relief process, the Bells discovered that they, like many of their neighbors, were underinsured.[223] Their insurance company provided them with immediate funds to cover their additional living expenses, which under their policy was limited to $2,500. The Bells have receipts to document that their excess living expenses for the loss period are well in excess of this amount and are likely to exceed $30,000. FEMA has provided them with a cash grant of $15,000 to cover some of the cost of their uninsured temporary housing; $5,100 for uninsured home repairs (maximum available) and another $5,500 to cover uninsured medical expenses incurred to treat Jennifer Bell's burns.

Because the Bells received the maximum dollar amount of assistance, or $25,600, that FEMA could provide in 2003, they must look to other sources for immediate disaster relief. Fortunately, they also received food stamps from the USDA's Emergency Food Stamp program. Jennifer Bell's mother sent them a check for $1,000 with her love and affection to help get them through this horrible time.

While many of the victims of the fire lost their homes, the Bells also lost their primary source of income when their family-owned and operated business, Wildcat Canyon Laundromat, was also burned to the ground. The Bells were self-employed, so they do not qualify for unemployment compensation under California law. However, because of President George W. Bush's declaration of the wildfires as a major disaster and their immediate loss of employment due to the disaster, they qualify for up to 26 weeks of unemployment compensation.

The Bells are working with their insurance company on the claims for their auto, home and its contents, and all of their business assets. Volunteer lawyers from the Young Lawyer's Division of the American Bar Association have been assisting them with the claims process by answering many questions

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222. See San Diego County Firestorms Aftermath: Information You Can Use, The San Diego Union-Trib., Nov. 2, 2003, at A13 (warning residents in unincorporated areas not to remove any debris from fire-damaged properties until assessment teams document losses); see also FEMA, Recovery Times, at 6 (Nov. 10, 2003) at www.fema.gov/pdf/rt/rt1498.pdf (providing safety tips for debris clean-up process).

223. See Jeannette Steele, After the Fires: Insurance Shortfall, The San Diego Union-Trib., Mar. 21, 2004, at B1, B5 (reporting that of Southern California wildfires victims "[a]t least half of the insured homeowners are underinsured" and nationwide "64 percent of U.S. homes were undervalued by an average of 27% on homeowners insurance policies"); Jeanette Steele, After the Fires: Owner Fears for Quality of Life, Ranch, The San Diego Union-Trib., Mar. 21, 2004, at B4 (describing the challenges of inadequate insurance coverage); Jeanette Steele, Agent Told Scripps Ranch Man He Had Enough Home Insurance, The San Diego Union-Trib., Mar. 21, 2004, at B4 (describing $223,362 shortfall to rebuild home that victim believed was adequately insured).

about the timing of the process; the extent of their coverage and because they have determined they are underinsured other potential sources of disaster relief. The Bells, like most of their neighbors, will not receive sufficient insurance proceeds to rebuild, so they have applied for low-interest SBA business and residential loans.

While the Bells have not yet received any payment from their insurance company for their damaged residential and business real and personal property, they have received payments for lost rental income and business income. In addition, to owning and operating Wildcat Canyon Laundromat, the Bells had rented a portion of their residential property to supplement their monthly income. The Bell's homeowner's insurance policy covers the fair rental value of their rental property less any expenses that will not continue while the property is uninhabitable. The Bell's business interruption insurance coverage will compensate them for lost business profits during the period of time their business must be closed, subject to certain specific time limitations. The insurance company has issued initial checks to them to compensate them for their lost business and rental income.

More than one month after the fires, the Bells spend long days and nights trying to manage their disaster relief. The Bells are overwhelmed with the consequences of the Southern California wildfires. As disaster relief begins to trickle in, they must add one more critical task to their endless "to do" list: Determine the tax consequences of their disaster relief.

a. Disaster Relief Assistance Excluded from Gross Income

All of the disaster relief assistance received by the Bells from FEMA, the Young Lawyers Division of the ABA (legal advice provided by FEMA through its agreement with the ABA), the Crisis Counseling Assistance and Training Program, and the USDA's Emergency Food Stamp program is excluded from their gross income under the general welfare exclusion. The food stamps from the USDA and $25,600 received from FEMA are also excluded from gross income under Code Section 139(b)(1)(personal living expenses) and (b)(2)(personal residence repair). The $1,500 received from their insurance company is excluded from gross income under Code Section 123(a). The shelter, food, clothing, counseling, and comfort kits received from the American Red Cross, the debris removal services from their community association and the $1,000 from Jennifer's mother are gifts excluded from gross income under Code Section 102. Finally, the proceeds from SBA disaster loans that the Bells anticipate receiving will not be included in gross income because it will not result in any accession of wealth.

b. Disaster Relief Assistance Included In Gross Income

The weekly unemployment compensation the Bells will be receiving over the next 26 weeks will be included in their gross income in the tax year in which the payments are received.[224] In addition, the insurance compensation the Bells receive for their lost rental income and lost business profits will be

224. See IRC § 85(a) (setting forth general rule that gross income includes unemployment compensation).

included in their gross income. Because the Bells operate their business, Wildcat Canyon Laundromat, as a sole-proprietorship, the reimbursement for lost business income is self-employment income, subject to self-employment taxes.[225] As the Bells try to prepare for the tax consequences of their disaster relief assistance to date, the most significant relief payments and tax issues will arise when they receive their anticipated insurance proceeds and must plan for the resulting casualty losses or gains.

B. Casualty Gains

When insured property is destroyed or damaged in a disaster, the disaster victim will receive insurance proceeds to compensate her for the loss. Under the Code, gross income includes "gains derived from dealings in property."[226] The receipt of insurance proceeds with respect to destroyed or severely damaged property is treated as a "dealing in property," or "a realization event."[227] A realization event will result in a gain or loss depending upon the relationship of the amount realized[228] to the taxpayer's adjusted basis in the property damaged or destroyed.[229]

If the amount realized by the insured[230] exceeds her adjusted basis in the property, the taxpayer has realized a gain equal to the excess.[231] Alternatively, if the amount received by the insured is less than her adjusted basis in the property, the taxpayer has realized a loss.[232] Generally, any gain or loss realized from a transaction must be recognized and included in gross income unless a nonrecognition provision applies.[233]

225. See Internal Revenue Service, Notice 2001-42, 2001-14 I.R.B. (answering frequently asked questions asked by victims of the Cerro Grande Fire in New Mexico)

226. See generally IRC § 165(c)(3).

227. A realization event or "dealing in property" occurs if the taxpayer's relationship with the property is changed in a manner that significantly reduces or terminates her property interest. See Eisner v. Macomber, 252 U.S. 189 (1920) (setting forth principle of realization); IRC §§ 165(h)(2)(B), 1001.

228. In general, amount realized is the economic benefit received by the taxpayer as a result of her dealing in the property. Regs. § 1.1001-1(a). Amount realized includes cash and the fair market value of property received as well as the amount of debt relief and any other benefits enjoyed. IRC § 1001(b).

229. A taxpayer's adjusted basis in property is her investment in the property (generally cost), IRC §§ 1011, 1012, adjusted for improvements, depreciation, and other statutorily required adjustments. IRC § 1016.

230. For this purpose, amount realized includes any amount paid on behalf of the disaster victim directly to a mortgagee, including any amount paid with respect to nonrecourse debt. Regs. § 1.1033(a)-2(c)(11).

231. See IRC § 1001(a)

232. Id.

233. See IRC§ 1001(c).

1. Recognition of Casualty Gains

Any net gain realized and recognized must be included in gross income.[234] If the property damaged is a capital asset,[235] the gain recognized generally will be characterized as a capital gain.[236] Moreover, if a taxpayer's casualty gains exceed her casualty losses on property that is used personally (and not in a trade or business or held for investment),[237] then her casualty gains and losses will be characterized as capital gains and losses, respectively.[238]

Under the Code, certain capital gains[239] receive favorable tax treatment.[240] Capital gains recognized from the disposition of property that had been held by the taxpayer for more than one year are characterized as long-term capital gains.[241] Alternatively, capital gains recognized from the disposition of property that had been held for one year or less are characterized as short-term capital gains.[242] Long-term and short-term capital gains must be offset by any current year (or carried-forward) long-term and short-term capital losses, respectively, to derive any net long-term and net short-term capital gains or losses.[243] Net long-term capital gains in excess of net short-term capital losses, are designated "net capital gains."[244] Net capital gains are subject generally to very favorable tax rates, which currently do not exceed fifteen percent.[245]

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234. See IRC §§ 61(a)(3), 63.

235. Capital assets are defined in the Code, by a negative inference or enumerated what types of property are not capital assets. IRC § 1221(a) (setting forth items that are not capital assets including inventory, depreciable property, copyright, account and notes receivables, and supplies). Accordingly, capital assets include a taxpayer's home, car, jewelry and other personal assets. See id.

236. See IRC § 1222 (defining short-term and long-term capital gains). Under certain circumstances, gain recognized from the sale or exchange of a capital asset held for more than one year may be recharacterized as ordinary income. See IRC §§ 1245 (recapturing generally as ordinary income all depreciation taken on personal property), 1250 (recapturing generally as ordinary income accelerated depreciation on real property), 1231(c) (recapturing generally as ordinary income long-term capital gains to the extent of ordinary losses enjoyed by the taxpayer in the prior five years).

237. IRC § 165(h)(3)(A), (B) (defining personal casualty gains and personal casualty losses).

238. IRC § 165(h)(2)(B).

239. IRC § 1222 (defining net capital gains as the excess of long-term capital gains over net short-term capital losses).

240. See IRC § 1(h) (setting forth maximum tax rates for net capital gains).

241. See IRC § 1222(3) (defining long-term capital gain).

242. See IRC § 1222(1) (defining short-term capital gain).

243. See IRC §§ 1222 (setting forth statutory requirement of offset of capital losses against capital gains); 1212 (describing capital loss carryforwards); 1211 (describing limits on current year recognition of capital losses).

244. IRC § 1222(11) (defining "net capital gain").

245. IRC § 1(h). However, long-term capital gain tax rates for gains on the disposition of collectibles (e.g., antiques, coins, stamps, etc.) are subject to tax at a maximum tax rate of 28% and long-term capital gains due to depreciation taken on real property is subject to tax at a maximum tax rate of 25%. Id.

2. *Nonrecognition of Casualty Gains*

While the tax rates for net capital gains are more favorable than the tax rates for other income, that is, ordinary income,[246] the recognition of a casualty gain will cost an innocent disaster victim precious dollars at a time when money is needed, often desperately, for replacement, repair and other unexpected expenses. Fortunately, disaster victims can elect under certain circumstances to defer recognition of all or part of their casualty gains.[247] The Code provides nonrecognition of gain when property is involuntarily converted[248] into cash and within a limited time period the taxpayer purchases qualified replacement property.[249]

This nonrecognition provision under the Code can provide welcome relief for many disaster victims who often plan to purchase replacement property irrespective of the tax consequences. If all requirements are satisfied, this tax provision eliminates the unexpected current tax liability resulting inadvertently from a disaster.

However, the tax liability for the gain realized is only deferred, because the tax basis in the replacement property is reduced by any gain not currently recognized.[250] The gain realized is deferred through the basis reduction and potentially recognized upon any subsequent sale or other realization event.[251] If a disaster victim does not reinvest all of her insurance proceeds received in

246. See IRC §§ 64 (defining ordinary income), 1(a)-(d) (setting forth a maximum tax rate of 35%).

247. See IRC § 1033(a)(2).

248. For this purpose, "involuntary conversion" includes destruction, in whole or in part, theft, seizure or requisition or condemnation or threat or imminence thereof. IRC § 1033(a). Property that is voluntarily sold may qualify for nonrecognition treatment if it is sold because of threat of condemnation or if the property is part of an "economic unit" with the converted property. Id.; Rev. Rul. 59-361, 1959-2 C.B. 183; Rev. Rul. 96-32, 1996-1 C.B. 177 (ruling that sale of residential lot after destruction of residence); Priv. Ltr. Rul. 9334007 (ruling that sale of land adjacent to house destroyed by tornado qualified for nonrecognition treatment under Code § 1033); Priv. Ltr. Rul. 9143056 (ruling that sale of lot underlying building destroyed by fire qualified for nonrecognition treatment); but see Rev. Rul. 78-377, 1978-2 C.B. 208 (disallowing nonrecognition treatment for voluntary sale because sale was not forced upon the taxpayer); Rev. Rul. 80-175, 1980-2 C.B. 230 (same).

249. See IRC § 1033(a)(2)(A), (B).

250. IRC § 1033(b)(2). If an electing property owner reinvests an amount in excess of her disaster relief proceeds (including loans) in qualifying property, she will increase her basis in the replacement property by any excess and decrease her basis by the gain realized but not recognized. Regs. § 1.1033(a)-2(c)(12).

251. See IRC § 1001 (setting forth the computation for determining gain or loss and the general rule that any gain realized must be recognized). If the property subsequently decreases in value gain may not be realized or recognized but any loss realized will be reduced. When the property's basis is determined by reference to a property received in exchange, including replacement property received in exchange for converted property, the holding period of the replacement property includes the holding period of the converted property. IRC § 1223(1)(A). This may allow a subsequent sale of the replacement property to qualify for long-term capital gain treatment even though the replacement property itself had been held for less than one year.

qualifying property within the requisite time period, she will have to recognize gain equal to any shortfall.[252] Notably, a disaster victim does not have to reinvest specifically her cash proceeds, she may acquire the replacement property with debt and use some or all of her cash proceeds for other purposes and qualify for nonrecognition treatment.[253]

In many cases, disaster victims desiring to rebuild their lives by replacing their damaged property will satisfy the nonrecognition requirements inadvertently. However, if the specific requirements are not satisfied the disaster victim would have to recognize her gain, albeit at potentially favorable tax rates.[254] A disaster victim who is unaware of these requirements could reinvest all of her insurance proceeds in property that does not qualify for nonrecognition treatment or property that does qualify, but after the close of the reinvestment period and owe tax dollars that she has spent. Because this nonrecognition provision has a number of detailed requirements[255] disaster victims should carefully plan the reinvestment of their insurance proceeds to ensure they receive the desired treatment.

a. Taxpayer Must Make a Valid Election for Nonrecognition Treatment

Nonrecognition treatment under this provision is elective.[256] A disaster victim makes the election by excluding all or some of her casualty gain from her annual federal income tax return.[257] The Regulations also require taxpayers to provide details regarding the gain realized including any information about the acquisition of replacement property, including the cost, description and date of acquisition.[258] However even if a taxpayer fails to include any information about her casualty gain from her return, the government will deem that she has made a nonrecognition election.[259] Taxpayers who make this election have also agreed to extend the statute of limitations for assessment of conversion-related deficiencies for up to three years after the taxpayer affirmatively notifies the government that she has or has not made a qualifying replacement for each tax year in which she realized any casualty gain.[260] Taxpayers are thereby

252. IRC § 1033(a)((2)(A).

253. See Rev. Rul. 68-642, 1968-2 C.B. 337; Rev. Rul. 68-362, 1968-2 C.B. 334; Ruud v. Comm'r, 28 T.C. Memo (CCH) 1284, (P-H) ¶ 69,252 (1969); Priv. Ltr. Rul. 8021126 (Feb. 29, 1980).

254. See IRC §§ 1001, 61(a)(3), 63.

255. See IRC § 1033.

256. IRC § 1033(a)(2)(A). However, if property is involuntarily converted directly into qualifying replacement property, then nonrecognition of gain is mandatory. IRC § 1033(a)(1).

257. Regs. § 1.1033(a)-2(c)(2).

258. Regs. § 1.1033(a)-2(c)(2). This information may be included on an amended tax return. See Priv. Ltr. Rul. 8424026 (Mar. 12, 1984).

259. Regs. § 1.1033(a)-2(c)(2).

260. See IRC § 1033(a)(2)(C). However, if replacement property is purchased before the beginning of the last tax year casualty gain is realized, any conversion-related deficiency may be assessed through the close of the statute of limitations for the latest tax year. IRC § 1033(a)(2)(D). This situation could occur if insurance proceeds are being contested and the insured replaces the property before the final settlement is received.

motivated to keep the government informed about their replacements to start the running of the extended statute of limitations.

Taxpayers who make this election may revoke or change it if sufficient qualifying replacement property is not acquired within the replacement period.[261] If the disaster victim fails to satisfy the replacement requirements, she must amend the return for the tax year in which the casualty gain was realized and include her casualty gain in her gross income.[262] Any applicable income taxes, interest, and penalties will be due and payable with the amended return.[263]

If a disaster victim files her tax return inadvertently or intentionally reporting her casualty gain and later decides she would like to defer its recognition, she may file an amended returning excluding the gain and making the nonrecognition election.[264] The taxpayer must file an amended return election before the expiration of the replacement period.[265] If the taxpayer timely satisfies the requirements for nonrecognition, she will receive a refund of any overpayment of taxes paid with respect to the original return.[266]

Fortunately, disaster victims have the luxury of time to determine whether or not they want to elect not to recognize their casualty gains. Individuals must file their annual federal income tax returns no later than April 15th of the following tax year, or as late as August 15th with an automatic extension and as late as October 15th with an additional discretionary extension.[267] Moreover, even if a disaster victim cannot make her decision by these dates, an election may be made on an amended return as long as it is within the several year replacement period.[268] However, this alternative would require that the taxpayer pay her tax liability upfront and later request a refund. Finally, the disaster victim can make the nonrecognition election and if she later decides not to reinvest all or some of her insurance proceeds she, will owe the government applicable income taxes, interest, and penalties with her amended tax return. To achieve the most efficient result, disaster victims should carefully analyze the foregoing alternatives before they file their tax return for the tax year in which their casualty gain was realized.

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261. Regs. § 1.1033(a)-2(c)(2); see Tech. Adv. Mem. 78-09-006 (1978) (interpreting the situations in which the election may be altered or revoked).

262. Regs. § 1.1033(a)-2(c)(2).

263. See Priv. Ltr. Rul. 9548005 (ruling that in addition to interest on the tax deficiency, late filing penalties were applicable).

264. Regs. § 1.1033(a)-(2)(c)(2).

265. See Santucci v. Comm'r, 32 T.C. Memo (CCH) 840, T.C. Memo (P-H) ¶ 73,178 (1973), (holding that an amended return election must be made before the close of the replacement period).

266. See Edwards, supra note 190, at A-18 (citing Rev. Rul. 63-127, 1963-2 C.B. 333, for the proposition that the refund claim must be filed within the statutory period for refund claims and not within the replacement period and recommending that cautious taxpayers file their refund claim within both time periods).

267. See IRC §§ 6072 (describing annual due date for individual income tax returns), 6081 (describing extensions for the due dates for filing tax returns); Regs. § 1.6081-4 (setting forth the details for an automatic extension of time for filing individual income tax returns).

268. Regs. § 1.1033(a)-(2)(c)(2).

b. Replacement Property Must be Similar or Related in Service or Use to the Converted Property

If a disaster victim makes a nonrecognition election for all or part of her qualifying casualty gains[269] she must use all or a portion of her disaster proceeds to purchase qualified replacement property.[270] Qualified replacement property is defined as property that is "similar or related in service or use" to the converted property.[271] While neither the Code nor the Treasury Regulations define what is "similar or related in service or use" property, the phrase has been the subject of significant litigation and administrative rulings.[272] The test for satisfaction of this requirement turns on whether the destroyed property was used by the owner or held as an investment.[273]

i. Owner Used the Converted Property

If the owner used the converted property, then the applicable inquiry is a "functional/end use test."[274] The replacement property must have closely similar physical characteristics and end uses to the converted property.[275] The replacement property must function in the same manner as the converted property.[276] The government strictly enforces this test and has denied nonrecognition treatment for an owner-user in the case of the replacement of a bowling alley with a billiard hall[277] and the replacement of a farm truck with a farm tractor.[278]

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269. See IRC § 1033(a) (describing the threshold requirement that property must have been compulsorily or involuntarily converted to qualify for nonrecognition treatment as a result of its destruction, theft, seizure, requisition or condemnation).

270. See IRC § 1033(a)(2)(A) (setting forth the requirement that if property is involuntarily converted into cash it must be reinvested in qualifying property).

271. IRC § 1033(a)(2)(A). In addition, to purchasing ualified replacement property outright, a disaster victim may purchase a controlling interest (or greater) in a corporation that owns property that qualifies as similar in service or use property. Id. For this purpose, a controlling interest is defined as 80% of the total combined voting power of all voting classes of stock, and 80% of the total number of shares of all other classes of stock. IRC § 1033(a)(2)(E)(i).

272. See Rev. Rul. 64-237, 1964-2 C.B. 319; Rev. Rul. 76-319, 1976-2 C.B. 242 (ruling that billiard facilities were not similar in use to bowling alley); Rev. Rul. 83-70, 1983-1 C.B. 189; Priv. Ltr. Rul. 8820055; Priv. Ltr. Rul. 9723032; Priv. Ltr. Rul. 200109005; Johnson v. Comm'r, 43 T.C. 736 (1965), acq., 1965-2 C.B. 5; Maloof v. Comm'r, 65 T.C. 263 (1975); Davis Regulator Co. v. Commissioner, 36 B.T.A. 437 (1937), acq., 1937-2 C.B. 7; Woodall v. Comm'r, 964 F.2d 361 (5th Cir. 1992).

273. See Edwards, supra note 190, at A-25.

274. Id.

275. See Rev. Rul. 56-347, 1956-2 C.B. 517; Edwards, supra note 190, at A-25 (noting that the property does not have to be exactly identical or the same).

276. See Internal Revenue Service, Casualties, Disasters, and Thefts, Pub. 547 at 9 (2003).

277. See Rev. Rul. 76-319, 1976-2 C.B. 242.

278. See Rev. Rul. 71-575, 1971-2 C.B. 61.

ii. Owner Invested in the Converted Property

If the owner is an investor in the property and leases the converted property to the end user, then the applicable inquiry is whether the relationship of the owner to the original property is the similar to the relationship of the owner to the replacement property.[279] The fact that the disaster victim was the lessor of both the converted and replacement properties is not enough.[280] Qualifying replacement property will include a lease that is similar to the converted property with respect to the nature and extent of the owner's management activities with respect to the property; the quantity and quality of the services required by the owner under the lease; and the nature of the property's business risk to the owner.[281] The government has allowed nonrecognition treatment for taxpayer/investors who replaced land and a leased warehouse with a leased gas station[282] as well as the replacement of a leased industrial warehouse with a residential apartment development.[283]

iii. Property Was Damaged or Destroyed in a Presidentially Declared Disaster

If the property was converted in a Presidentially declared disaster[284] and it was held for investment or used in a trade or business, then more liberal replacement property rules apply.[285] Under these circumstances, qualifying replacement property is any tangible property used in any trade or business.[286] This provision will allow a disaster victim of a Presidentially declared disaster to qualify for nonrecognition of gain by replacing her destroyed investment or trade or business property with any type of tangible business property in any trade or business, including an existing business.[287] This exception to the general rule affords disaster victims with a broad array of reinvestment options.

279. Rev. Rul. 64-237, 1964-2 C.B. 319. See Liant Record, Inc. v. Comm'r, 303 F.2d 326 (2d Cir. 1962); Clifton Inv. Co. v. United States, 312 F.2d 719 (6th Cir. 1963), cert. Denied, 373 U.S. 921 (1964); Loco Realty Co. v. United States, 306 F.2d 207 (8th Cir. 1962); Pohn v. Comm'r, 309 F.2d 427 (7th Cir. 1962); Johnson v. Comm'r, 43 T.C. 736 (1965), acq. 1965-2 C.B. 5.

280. See Priv. Ltr. Rul. 8820055; Priv. Ltr. Rul. 9723032.

281. See Liant Record, Inc., 303 F.2d at 329.

282. Rev. Rul. 71-41, 1971-1 C.B. 223 (allowing taxpayer to satisfy requirements for replacement property by constructing leased gas station on property already owned).

283. Priv. Ltr. Rul. 9326042 (determining whether an apartment building is similar to destroyed warehouse).

284. IRC § 1033(h)(3) (defining Presidentially declared disaster for this purpose as "any disaster which, with respect to the area n which the property is located, resulted in a subsequent determination by the President that such area warrants assistance by the Federal Government under the Disaster Relief and Emergency Assistance Act").

285. IRC § 1033(h)(2).

286. Id.

287. See Tech. Adv. Mem. 2001-11-056 (advising that while replacement property is broadly interpreted it does not include property held for investment).

In addition, if the property was converted in a Presidentially declared disaster and it was the taxpayer's principal residence[288] or any of its contents, the Code does not require reinvestment of insurance proceeds received for any personal property contents that were not specifically scheduled insured items.[289] Therefore, a Presidentially declared disaster victim can use insurance proceeds from the destroyed unscheduled contents of her home for any purpose and not have to recognize any gain realized with respect such property.[290] Moreover, insurance proceeds received for personal property that is scheduled for insurance purposes may be pooled with the proceeds received for the residence itself and reinvested in property that is similar or related in service or use property to the residence (or its contents).[291] This flexibility affords disaster victims with different tax-favored options for replacing their home and contents.

c. Replacement Property Must Be Purchased Within the Applicable Time Period

To qualify for nonrecognition of gain realized, the replacement property must be purchased[292] no later than two years after the close of the first taxable year in which any conversion gain is realized.[293] Gain is realized as soon as proceeds exceed the taxpayer's basis in her property.[294] A more liberal four-year replacement period applies for the involuntary conversion of a principal residence resulting from a Presidentially declared disaster.[295] While these time periods may at first impression seem generous, the replacement process can be very time consuming and due to circumstances outside of the control of the taxpayer take many years.[296] Fortunately, the Code provides that

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288. See IRC § 1033(h)(4) (defining principal residence for this purpose as the same meaning as used in Code § 121, except that the taxpayer is not required to own the property).

289. IRC § 1033(h)(1)(A)(i); Rev. Rul. 95-22, 1995-1 C.B. 145.

290. Id.

291. IRC § 1033(h)(1)(A)(ii).

292. IRC § 1033(a)(2)(A) (stating that replacement property must be purchased); Regs. § 1.1033(a)-2(c)(4). Taxpayers may acquire replacement property by constructing it as long as it is paid for and completed by the close of the replacement period. See Rev. Rul. 56-543, 1956-2 C.B. 294. If an individual taxpayer's aggregate realized gain exceeds $100,000 for all converted gain property, then nonrecognition treatment is not available for replacement property purchased from a related party. IRC § 1033(i)(2)(C). Corporate taxpayers and certain partnerships with corporate partners are denied nonrecognition treatment for replacement properties acquired from related parties under any circumstance. IRC §1033(i)(2)(A), (B). For purposes of this analysis, related parties are defined in Code §§ 267(b) (including, without limitation, brothers, sisters, spouse, ancestors and lineal descendants, an individual and a more than 50% owned-corporation) or 707(b)(1) (including, without limitation, an individual and a more than 50% owned partnership). IRC § 1033(i)(3).

293. IRC § 1033(a)(2)(B).

294. IRC § 1001(a) (setting forth the calculation for determining gain).

295. IRC § 1033(h)(1)(B).

296. See for example Mike Freeman, Jennifer Davies and Roger M. Showley, End in Sight: Rebuilding May Be Long Process for Homeowners, The San Diego Union-Trib., Nov. 2, 2003, at A-1, A-11 (noting that because of the overwhelming loss of

the taxpayer may apply to the government for a discretionary extension of the replacement period.[297]

An application for an extension of the replacement period should be made before the replacement period expires.[298] However, the IRS usually does not grant them until very near the end of the period.[299] Under certain circumstances, the IRS may extend the replacement period even if the request is filed after the close of the replacement period.[300] Extensions of the replacement period are only granted if there is reasonable cause for the failure to make timely replacement and, if applicable, reasonable cause for the late filing of the extension request.[301] The IRS usually grants extensions for periods of one year or less when the taxpayer has demonstrated that she has made diligent and timely efforts to find replacement property.[302] Disaster victims are well advised to keep a written journal and any relevant newspaper or magazine articles documenting their efforts to obtain qualifying replacement property and any specific challenges during the process. This journal, together with any supporting independent evidence, should provide a ready source of information for an extension request if it should become necessary near the end of the relevant replacement period.

d. Conversion of Principal Residence

If the property destroyed is the taxpayer's principal residence, taxpayers may elect to exclude some or all of the gain realized under an alternative provision of the Code.[303] Code Section 121 is an elective provision that permits taxpayers who have owned and lived in their principal residence

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homes San Diego County would be embarking upon its biggest rebuilding effort in history and that it would be a long (12 to 18 months of planning and construction) and challenging process for residents and the ill-equipped construction industry); Ron Harris, Lack of Workers May Delay Fire Rebuilding, Los Angeles Times, Nov. 9, 2003, at Real Estate (commenting that even if homeowners can find a builder it could be weeks before some areas are safe due to intense heat leaving roads unstable due to oil boiled out of the pavement); Roger M. Showley, Rebuild? A Series of Hurdles Ahead, The San Diego Union-Trib., Nov. 2, 2003, at H8 (reporting that rebuilding a home isn't what it used to be).

297. IRC § 1033(a)(2)(B)(ii). The application for extension should be addressed to the district director for the Internal Revenue district in which the return was filed for the first taxable year in which gain from the conversion was realized. Regs. § 1.1033(a)-2(c)(3).

298. Id.; Rev. Rul. 60-69, 1960-1 C.B. 294 (indicating that extension requests are generally not granted until the end of the replacement period).

299. Id.; Regs. § 1.1033(a)-2(c)(3).

300. See Rev. Rul. 56-300, 1956-1 C.B. 624.

301. See Edwards, supra note 190, at A-38 through A-39 (presenting examples of reasonable causes that the government has accepted and rejected including the rejection of scarcity and high values of replacement property or shortage of condemnation proceeds and accepting death (but not inexperience) and miscalculations by tax advisor).

302. Id.

303. See IRC § 121(d)(5) (setting forth provision providing for the exclusion of gain from the sale of a principal residence and treating an involuntary conversion as a sale or exchange for this provision); Regs. § 1.121-4(d)(1).

for at least two of the last five years to exclude $250,000 ($500,000 for married filing joint taxpayers) of gain realized from gross income.[304] This provision provides for the complete exclusion rather than mere deferral of gain realized and does not require any reinvestment of sale proceeds.[305] This tax provision is unique because the tax benefit comes at no cost or basis reduction in the replacement property.[306]

Disaster victims may elect to use this gain exclusion provision in lieu of or in addition to electing to defer any excess gain under the involuntary conversion provision.[307] Disaster victims with casualty gains on their principal residences in excess of $250,000 ($500,000 for married filing jointly) may want to use both provisions to exclude from gross income the maximum allowable (e.g., $250,000 for unmarried or married filing separately taxpayers) and defer any excess gain under the nonrecognition involuntary conversion provisions.[308] This strategy will allow disaster victims to benefit to the extent allowable from the generous principal residence gain exclusion provision and to the extent of any additional gain, the casualty gain deferral provisions.

Technically, the Code requires taxpayers to reduce the amount realized from the involuntary conversion by the amount of any gain excluded.[309] Taxpayers desiring to defer all gain realized in excess of the allowable exclusion amount will have to reinvest in qualified replacement property within the replacement period.[310] The amount that must be reinvested is the total amount of insurance proceeds received reduced by the amount of excluded gain.[311] If a taxpayer elects to reinvest in qualified replacement property, the taxpayer's ownership and use of the destroyed residence is attributed to the replacement residence for purposes of excluding gain on a subsequent sale of the replacement residence.[312]

3. Application to the Bell Family, Hypothetical Disaster Victims

After submitting detailed lists, photographs, and engaging in weeks of intense negotiations, the Bell family received insurance proceeds for their business and residential assets. The initial insurance checks came in late December, just after the less than festive holiday season. The insurance checks were separately allocated between the Bell's business and residence and their personal and real property losses.

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304. See IRC § 121(a), (b) (applying this exclusion provision generally to only one sale or exchange every two years).

305. See IRC § 121.

306. See for example IRC §§ 1031(d) (carryover basis in like-kind exchange); 1033(b) (cost basis reduced by gain realized but not recognized); 1091(d) (carryover basis increased by new investment and decreased by cash withdrawn); 1032(b) (carryover basis).

307. See IRC § 121(d)(5)(B); Internal Revenue Service, Casualties Disasters, and Thefts, Pub. 547, at 10.

308. Id.

309. IRC § 121(d)(5)(B).

310. Id.

311. Id.

312. IRC § 121(d)(5)(C); Regs. § 1.121-4(d)(3).

The Bells received $50,000 for their business equipment, which was comprised primarily of commercial washers and dryers. Because these items had been held for several years, the Bell had fully depreciated them,[313] so their adjusted basis in the equipment had been reduced to zero.[314] Therefore, the Bells realized a $50,000 gain on the involuntary conversion of the equipment.[315] In addition, the Bells received insurance proceeds of $150,000 for their destroyed business structure. The Bells had acquired their business property several years ago for $350,000, $125,000 of which was allocated to the land and the balance of $225,000 was allocated to the structure. The building had been depreciated and had a basis on the date of its destruction of $205,000.[316] Accordingly, the Bells have realized a $55,000 casualty loss on their business structure.[317]

The Bells have also received insurance reimbursements for their residence and the contents of their residence. The insurance proceeds will be $150,000 for their home and $35,000 for lost contents, including $5,000 for specifically scheduled jewelry. The Bells had acquired their home approximately fifteen years ago for $100,000, which was allocated $30,000 to land and $70,000 to the structure. The Bells had a cost basis[318] in their lost contents including furniture, fixtures, clothing and household appliances of approximately $44,000, including $4,000 basis in their jewelry. Accordingly, the Bells have an $80,000 gain on their residence[319] and a $10,000 personal casualty loss on their residential contents and a $1,000 personal casualty gain on their scheduled property.[320]

The Bells' casualty gains result from a disaster declared a major disaster by President George W. Bush. Accordingly, more favorable rules apply if they want to qualify for tax-deferred treatment of their gains. For example, the Bells may qualify for tax-deferred treatment if they reinvest their business insurance proceeds from the involuntary conversion of their laundromat assets in any tangible trade or business property.[321] This treatment is much more generous than the much narrower reinvestment requirement for trade or

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313. See IRC §§ 179, 167, 168 (setting forth provisions for immediate expensing and depreciation of trade or business property, respectfully).

314. See IRC §§ 1012 (setting forth definition of adjusted basis), 1011 (setting forth definitions of cost basis), 1016 (setting forth adjustments to basis to derive adjusted basis).

315. Fifty thousand dollars (amount realized) less $0 (adjusted basis of equipment) = $50,000 gain realized. See IRC § 1001(a).

316. The building would have been depreciated on a straightline basis over a 39-year recovery period. See IRC § 168(b)(3), (c) (setting forth the depreciation method and recovery period for nonresidential real property); 225,000/39 = $5,769 per year/12 = $480.76 per month for almost 42 months or almost 3.5 years = $20,000 of depreciation reducing the basis to 205,000. See IRC §§ 1012, 1016 (setting forth how depreciation reduces basis to derive adjusted basis).

317. One hundred fifty thousand dollars (amount realized) less $205,000 (adjusted basis of building) = $55,000 loss realized. See IRC § 1001(a).

318. See IRC § 1011.

319. One hundred fifty thousand dollars (amount realized) less $70,000 (adjusted basis) = $80,000 gain.

320. Thirty thousand dollars (amount realized) less $40,000 (adjusted basis) = ($10,000) loss; $5,000 (amount realized) less $4,000 (adjusted basis) = $1,000 gain.

321. See IRC § 1033(h)(2).

business or investment property destroyed in a non-Presidentially declared disaster. Under the later, more narrow case, property must be reinvested in "similar or related in service or use" property.[322] Under such circumstances, to avoid recognition of their business casualty gain the Bells would have to reinvest their insurance proceeds in commercial washers and dryers.

However, because the property was destroyed in a Presidentially declared disaster, the Bells might avoid recognition by reinvesting all $50,000 of their insurance proceeds from their destroyed washers and dryers in any tangible trade or business property.[323] If the Bells decide to reinvest less than $50,000 in trade or business tangible property, they will have to recognize any reinvestment shortfall as ordinary income in 2003.[324] For example, if the Bells reinvest only $45,000 in qualifying property, they will have to recognize $5,000 of ordinary income and their basis in their new business property will be zero.[325] In 2003, the highest marginal ordinary income tax rate was thirty-five percent.[326] If the Bells decide not to reinvest any insurance proceeds in qualifying replacement property, their maximum federal income tax cost would be $17,500.[327]

The Bells do not have to use their cash insurance proceeds but may finance all or some of their reacquisition as long as they purchase qualifying replacement property within the replacement period.[328] The Bells basis in their new property will be their cost reduced by any gain realized but not recognized.[329] Accordingly, if the Bells purchase $50,000 of trade or business replacement property, their basis in the new property will be zero.[330] Any reinvestment of the Bells business insurance proceeds must occur no later than December 31, 2005 to avoid recognition.[331] The Bells will have to elect nonrecognition treatment on their 2003 income tax return by filing a statement detailing the involuntary conversion and their reinvestment plans.[332] This election will extend the Bells' statue of limitations with respect to any deficiency related to this casualty gain to three years from the date the Bells notify the government of their reinvestment or failure to reinvest in qualifying replacement property.[333]

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322. See IRC § 1033(a)(2)(A).

323. See IRC § 1033(h)(2).

324. See IRC §§ 1033(a)(2)(A); 1245(a) (describing recapture of depreciation taken as ordinary income).

325. Forty-five thousand ollars (cost basis) – $45,000 (gain realized, but not recognized) = $0 basis in replacement property. See IRC § 1033(b)(2) (describing the basis computation).

326. See IRC § 1(a) (setting forth marginal income tax rates for married individuals filing joint returns).

327. Thirty-five percent marginal income tax rate x $50,000 ordinary income = $17,500.

328. See IRC § 1033(a)(2)(A).

329. See IRC § 1033(b)(2).

330. Fifty thousand dollars cost less $50,000 gain realized, but not recognized = zero.

331. See IRC § 1033(a)(2)(B).

332. See IRC § 1033(a)(2)(A).

333. See IRC § 1033(a)(2)(C).

The casualty gain on the involuntary conversion of the Bell's principal residence may be excluded under the residential gain exclusion provisions.[334] Under this provision the Bell's may exclude up to $500,000 of gain irrespective of any reinvestment in qualifying property.[335] If the Bells casualty gain exceeded $500,000, they could defer recognition of any excess gain by reinvesting in a new principal residence.[336] For example, if the Bells' gain were $600,000 and they had received $800,000 of insurance proceeds, the Bells would have to reinvest at least $300,000, or the amount of the insurance proceeds reduced by the excluded gain, in a new residence to defer recognition of the $100,000 of gain in excess of the excluded gain of $500,000.[337] The Bells' basis in their new home would be its purchase price, including debt, less any gain realized (reduced by gain excluded under the principal residence provisions) but not recognized. If the Bells reinvested $275,000 in a new principal residence, the home's basis would be $250,000[338] and $575,000 gain realized would be excluded ($500,000) or deferred ($75,000) and $25,000 long-term capital gain ($300,000 less 275,000) would be recognized at a preferable maximum tax rate of fifteen percent. Any reinvestment to defer gain under the involuntary conversion rules would have to be completed no later than December 31, 2007.[339]

The $1,000 gain on the Bells' jewelry, scheduled residential contents, may be deferred if the $5,000 insurance proceeds are reinvested in "similar or related in service or use property" expanded for this purpose to include the residential structure in addition to the destroyed jewelry.[340] Therefore, if the Bells reinvest their $5,000 of insurance proceeds in replacement jewelry or with other funds in their new residence, they will not have to recognize any of their $1,000 casualty gain. Any shortfall of reinvestment will give rise to casualty gain equal to the amount of the shortfall (limited to the amount of gain realized).[341]

The Bells suffered a personal casualty loss on the involuntary conversion of their residential contents because the insurance proceeds they received were less than the cost of the unscheduled and scheduled contents.[342] If the insurance proceeds had exceeded the cost of their contents (resulting in a realized gain), they could have excluded from recognition any gain on

334. See IRC § 121 (setting for the rules for exclusion of gain for sales or exchanges of principal residences).

335. IRC § 121(b)(2)(A).

336. IRC § 121(d)(5) (describing the coordination rules for exclusion and deferral of gain realized on the involuntary conversion of a principal residence).

337. See IRC § 121(d)(5)(B).

338. Four hundred thousand dollars cost basis less $100,000 (gain realized ($600,000 – $500,000 = $100,000), but not recognized) = $300,000.

339. See IRC § 1033(h)(1)(B) (setting forth the four year replacement period).

340. IRC § 1033(h)(1)(A)(ii) (providing that insurance proceeds for scheduled property may pooled with insurance proceeds for the residence for reinvestment in a new residence).

341. See IRC § 1033(a)(2)(A).

342. The Bells had an adjusted basis of $45,000 in their destroyed contents and received $35,000 insurance proceeds.

unscheduled residential contents because the gain resulted from a Presidentially declared disaster.[343]

The Bells project a budget of $335,000 to rebuild and re-equip their business and $450,000 to rebuild their home and acquire basic furnishings. Their total insurance proceeds are $385,000. The Bells need a minimum of $785,000 to reestablish their pre-fire lives and, therefore, have a $400,000 shortfall. The Bells have applied for SBA loans and have been notified that they qualify for a $100,000 residential loan and a $150,000 business loan. As a result, the Bells need an additional $150,000 to reestablish the basic components of their pre-disaster lives.

Alternatively, the Bells could decide not to rebuild their lost laundromat. If they decide not to rebuild, they could use the insurance proceeds from the loss of their equipment and business structure for the reconstruction of their residence. The Bells would owe up to $17,500[344] of federal income tax as a result of not reinvesting in qualifying replacement property, but they would have enough cash to re-establish their home by accepting most or the entire $100,000 SBA residential loan.

As part of this plan, the Bells may decide to sell the land underlying their laundromat. If they sell this land, they will have to recognize any gain or loss realized and will not receive favorable treatment unless they can demonstrate that the entire property was one economic unit effectively destroyed in the disaster.[345] Alternatively, the Bells could exchange the former laundromat land for other real property. The Code provides deferral of gain recognition if real property held for investment or in a trade or business is exchanged for other real property to be held in a trade or business or for investment purposes.[346] Under this alternative, the Bells should be able to exchange their former laundromat property for another business or investment property without recognizing any gain. However, the Bells may lack the cash resources or emotional energy to begin a new business in a new location.

Another option would be for the Bells to sell their residential property, buy a less expensive home, and use the excess funds to rebuild their business. Any gain from the sale of the residential property should be excluded under the exclusion provision for gains on the sale of a principal residence.[347] Any gain

343. IRC § 1033(h)(1)(A)(i) (providing an exclusion of gain realized for insured, nonscheduled personal property).

344. Fifty thousand dollars of gain realized and recognized as ordinary income subject to a maximum tax rate of 35%.

345. Property that is voluntarily sold may qualify for nonrecognition treatment if it is sold because the property is part of an "economic unit" with the converted property. Id.; Rev. Rul. 59-361, 1959-2 C.B. 183; Rev. Rul. 96-32, 1996-1 C.B. 177 (ruling that sale of residential lot after destruction of residence qualified for nonrecognition treatment); Priv. Ltr. Rul. 9334007 (ruling that sale of land adjacent to house destroyed by tornado qualified for nonrecognition treatment under Code § 1033); Priv. Ltr. Rul. 9143056 (ruling that sale of lot underlying building destroyed by fire qualified for nonrecognition treatment); but see Rev. Rul. 78-377, 1978-2 C.B. 208 (disallowing nonrecognition treatment for voluntary sale because sale was not forced upon the taxpayer); Rev. Rul. 80-175, 1980-2 C.B. 230 (same).

346. See IRC § 1031 (setting forth the gain deferral provisions for like-kind exchange).

347. See IRC § 121.

on the land and property in excess of $500,000 could be deferred under the involuntary conversion provisions if a new residence is acquired no later than December 31, 2007.[348] The Bells could use excess residential sale proceeds to supplement their insurance and loan proceeds to rebuild their business and its contents and perhaps even provide some working capital. For example, if the Bells sold their residential lot for $530,000, they would realize a $500,000 gain on its sale in addition to the $80,000 gain on the involuntary conversion of their residential structure. The Bells would have to pay in full their $200,000 home mortgage. As a result, their net proceeds from their residential property, including contents, would be approximately $465,000.[349] The $465,000 of net proceeds on their residence could be used together with their business insurance proceeds of $200,000 to acquire a new, less expensive home and business. In addition, the Bells could retain some of this $665,000 cash for other purposes such as working capital for their business and use debt including any approved SBA loans to re-establish their home and business. To avoid recognition of any casualty gain realized, the Bells would have to purchase a residence for at least $155,000 (insurance proceeds with respect to their residence and scheduled jewelry) and business property costing at least $50,000. This minimal amount of reinvestment to avoid gain recognition by the Code is likely significantly less than the marketplace will demand.

The Bells have many different options for minimizing the tax costs of their casualty gains and re-establishing their home and business. Unfortunately, the Bells may have to incur more debt, so they must carefully analyze their future cash flow to ensure that they can support any increased level of indebtedness. The Bells should consult competent professionals to assist them in their tax and financial analyses. The Bells will also want to ensure that they maximize any tax benefits from their realized casualty losses.

C. Casualty Losses

Disaster victims may realize casualty losses in addition to or in lieu of realizing casualty gains.[350] Casualty losses must be attributable to a loss of property and do not include any unreimbursed additional living expenses resulting from a casualty.[351] Under the Code, casualty losses generally arise

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348. See IRC § 1033(h)(1)(B); Rev. Rul. 96-32, 1996-1 C.B. 177 (ruling that sale of residential lot qualified for nonrecognition treatment even though it was not involuntarily converted as long as the sale occurs within the statutory replacement period).

349. One hundred eighty-five thousand dollars residence and contents insurance proceeds + $480,000 net sale proceeds (after $50,000 estimated selling costs) = $665,000 - $200,000 home mortgage = $465,000.

350. See Internal Revenue Service, Casualties, Disasters, and Thefts, Pub. 547, at 13-14; McCoy, supra note 356, at A-93 through A-94; IRC § 172(a), (b)(1)(F) (describing three-year carryback period for any casualty losses incurred by individuals and farmers and small businesses and farmers with Presidentially declared disasters). Alternatively, the carryback period for net operating losses is two years. IRC § 172(b)(1)(A)(i).

351. See Rev. Rul. 59-398, 1959-2 C.B. 76; Millsap v. Commissioner, 46 T.C. 751 (1966), acq., 1967-1 C.B. 2, aff'd, 387 F.2d 420 (8th Cir. 1968). Unfortunately, this means that the Bells will not receive any tax benefit for their uninsured and

when disaster relief received for damaged or destroyed property is less than the taxpayer's adjusted basis in her property.[352] In most cases, the loss may not exceed the taxpayer's decrease in the value.[353] Accordingly, the loss is limited to the taxpayer's actual investment in the property and no deduction is allowed for a loss in unrealized appreciation in the property.[354]

In cases where property values have appreciated greatly and insurance coverage is inadequate,[355] the decline in the property's value will exceed the insurance proceeds, giving rise to a nondeductible loss in unrealized appreciation.[356] Because the insurance proceeds exceed the taxpayer's adjusted basis in her property, the taxpayer has realized a casualty gain and not a casualty loss.[357] A disaster victim may be agonizing over her significant economic loss without realizing that under the Code she has a taxable gain. Fortunately, as demonstrated above, the disaster victim may qualify for nonrecognition of her realized casualty gain. Even if a taxpayer has suffered a tax loss, recognition under the Code is limited.

The Code generally only permits individual taxpayers deductions for losses incurred in a trade or business or a transaction entered into for profit.[358] Personal losses are generally not deductible.[359] The one exception to this general rule is that if the loss arises from fire, storm, shipwreck, or other casualty or theft, the loss is allowable.[360] For this purpose, a "casualty" is defined by the government as "the damage, destruction, or loss of property resulting from an identifiable event that is sudden, unexpected, or unusual."[361]

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uncompensated additional living expenses resulting from the fire. The Bells estimated that these costs were in excess of $10,000.

352. See Regs. § 1.165-7(b)(1) (setting forth rule for determining the amount of the loss for a qualifying casualty loss).

353. Id. The exception to this rule is if the property was used in a trade or business or held for the production of income and it is totally destroyed by the casualty. Regs. § 1.165-7(b)(1)(ii).

354. This result may not be true if a taxpayer inherited the property and received a stepped-up basis in the property, which represents appreciation in the property that has never been subject to income tax. See IRC § 1014(a).

355. See for example Jeannette Steele, After the Fires: Insurance Shortfall, The San Diego Union-Trib., Mar. 21, 2004, at B1, B5 (describing that because of significant insurance shortfalls many fire victims will need second mortgages or drain their savings accounts to rebuild); Jeanette Steele, After the Fires: Owner Fears for Quality of Life, Ranch, The San Diego Union-Trib., Mar. 21, 2004, at B4 (describing the challenges of inadequate insurance coverage); Jeanette Steele, Agent Told Scripps Ranch Man He Had Enough Home Insurance, The San Diego Union-Trib., Mar. 21, 2004, at B4 (describing $223,362 shortfall to rebuild home that victim believed was adequately insured).

356. See John C. McCoy, Esq., Loss Deductions, 527-2d Tax Management Portfolio (explaining that a taxpayer cannot claim a loss on income that has not been recognized for tax purposes).

357. See IRC § 1001(a).

358. See IRC§ 165(c)(1), (2).

359. IRC § 165(c).

360. IRC § 165(c)(3).

361. Internal Revenue Service, Casualties, Disasters, and Thefts, Pub. 547, at 2 (defining "sudden" as swift, not gradual or progressive; "unexpected" as ordinarily unanticipated and unintended; and "unusual" as not a day-to-day occurrence and not typically engaged in).

Major disasters[362] and emergencies[363] declared by the President under the Disaster Relief and Emergency Assistance Act will qualify as a casualty for purposes of this tax relief.[364] Taxpayers also have the burden of proving that the damage or destruction to property was the direct result of the "casualty."[365]

In addition, a taxpayer has the burden of proving the amount of her casualty loss.[366] The government advises that the best evidence of the decrease in value includes competent appraisals of the fair market value of the property immediately before and after the casualty.[367] If a taxpayer's casualty loss is from a Presidentially declared disaster appraisals, she may use any appraisals obtained for federal loans.[368] Alternatively, a disaster victim may use the cost to repair the property to its original condition as evidence of the decrease in value as long as the repair is only necessary to bring the value of the property to its pre-casualty level.[369] The cost of removing debris and other clean-up work should be including in calculating the decrease in the property's value by including it in repair costs or in appraised values.[370]

Disaster relief reimbursements actually received or reasonably anticipated with respect to the damaged property reduce the amount of the

362. Major disasters are defined as a natural catastrophe including a hurricane, tornado, storm, flood, and drought. 42 U.S.C. § 5122(1). For purposes of Code § 165(c)(3), drought may or may not qualify as a casualty due to its progressive rather than sudden, unexpected nature. Rev. Rul. 77-490, 1977-2 C.B. 64.

363. An emergency is broadly defined as "any occasion or instance" requiring federal assistance. 42 U.S.C. § 5122(2).

364. See McCoy, supra note 356, A-69 (commenting that as a practical matter the IRS will likely agree with the President for determining whether an event is a casualty).

365. Regs. § 1.165-7(a)(2)(i) (stating that the loss is limited to actual damage resulting from the casualty and not due to a decrease in value due to general market decline resulting from the casualty); see Rev. Rul. 66-242, 1966-2 C.B. 56 (ruling that loss does not include general economic decline of the property resulting from buyer resistance due to the casualty); see also Caan v. United States, 99-1 U.S.T.C. ¶ 50,349 (C.D. Cal. 1999) (denying casualty loss deduction for decline in value due to buyer resistance attributable to the close proximity of the property to the residence of O.J. Simpson during his double murder trial).

366. See Regs. § 1.165-7(b)(1). The "bluebook" value (but not the trade-in value) of an automobile as adjusted for mileage and condition may provide evidence as its pre-casualty value. Internal Revenue Service, Casualties, Disasters and Thefts, Pub. 547, at 4. For an excellent analysis of the myriad of caselaw covering the success and failure of taxpayers' attempts to prove their casualty loss through a wide range of appraisals, see McCoy, supra note 356, at A-86 through A-88.

367. Regs. § 1.165-7(a)(2)(i). The appraisal may not include any general market decline due to the casualty. Id. Any costs (e.g., appraisals and photographs) incurred to determine the casualty loss are deductible as expenses related to tax preparation deductible as miscellaneous itemized deductions, which are in the aggregate only deductible as itemized deductions to the extent they exceed two percent of adjusted gross income. See IRC § 67(a); Internal Revenue Service, Casualties, Disasters, and Thefts, Pub. 547, at 4.

368. Id.; IRC § 165(i)(4).

369. Regs. § 1.165-7(a)(2)(ii).

370. See Internal Revenue Service, Casualties, Disasters and Thefts, Pub. 547, at 4; Rev. Rul. 71-161, 1971-1 C.B. 76 (noting that the cost of debris removal must be included in computing casualty loss); McCoy, supra note 356, at A-83.

casualty loss.[371] For this purpose, all insurance proceeds, federal and state reimbursements, charitable or employer received or reasonably anticipated reimbursements specifically for restoration, repair or rehabilitation of the damaged or lost property reduce the amount of the casualty loss.[372] Unrestricted gifts or loans or reimbursements for living expenses are not treated as recoveries for purposes of this analysis.[373] Legal, accounting and other expenses incurred to obtain property reimbursements offset the amount of any recovery.[374] If anticipated reimbursements are no longer receivable in full or in part, the disaster victim may deduct any resulting loss in the tax year of this discovery.[375] If actual reimbursements are greater than anticipated, then the excess reimbursement will have to be included in gross income to the extent of any tax benefits previously enjoyed by the taxpayer.[376]

The amount of realized loss that is deductible depends upon whether the property is used personally, in a trade or business, or held for investment.[377]

1. Personal Casualty Losses

Personal-use property is defined as any property that is not used in a trade or business or held for investment.[378] The amount of casualty loss for personal-use property is the lesser of (1) the decrease in the fair market value of the property immediately before and after the casualty; or (2) the adjusted basis in the property.[379] As noted above, the taxpayer must reduce this amount by any insurance proceeds or other reimbursements received or recoverable, including any salvage value.[380] Taxpayers with damage to personal-use property must file a timely insurance claim for any damaged insured property or the loss will be denied.[381]

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371. IRC § 165(a); see Internal Revenue Service, Casualties, Disasters and Thefts, Pub. 547, at 4.

372. Id.; Regs. § 1.165-1(d)(2)(i); Tech. Adv. Mem. 2001-11-056 (Feb. 15, 2001) (finding that losses were not deductible because disaster victim had reasonable prospect of a recovery); Spak v. Comm'r, 76 T.C. 464 (1981), acq., 1981-2 C.B. 2.

373. Id.

374. See Jeffrey v. Comm'r, 12 T.C. Memo 534 (1953) (holding that legal fees to obtain insurance recovery offset insurance proceeds eventually received); but see Tarsey v. Comm'r, 56 T.C. Memo 553 (1971) (holding that legal fees incurred for unsuccessful pursuit of recovery for personal casualty loss were not deductible).

375. See Internal Revenue Service, Casualties, Disasters, and Thefts, Pub. 547, at 5-6 (describing the tax consequences of receiving reimbursements greater or less than the amount anticipated after the year of the disaster).

376. Id.; see IRC § 111.

377. IRC § 165(h) (describing the different tax treatment for personal casualty losses as compared to business or investment casualty losses).

378 IRC § 165, (h)(3) (describing personal casualty losses resulting from personal-use property, which is property that is not used in a trade or business or held for investment).

379. Regs. § 1.165-7(b)(1).

380. IRC § 165(a); Regs. § 1.165-1(c)(4).

381. IRC § 165(h)(3)(E). A claim does not have to be filed if the loss is less than the amount of the insurance policy deductible because the loss is not insured. See Internal Revenue Service, Casualties, Disasters, and Thefts, Pub. 547, at 7.

Each taxpayer[382] must further reduce her personal casualty losses by $100 for each casualty.[383] All personal casualty losses must then be offset against all recognized personal casualty gains.[384] If personal casualty losses exceed personal casualty gains, such excess is further reduced by ten percent of a taxpayer's adjusted gross income.[385] The balance of any personal casualty loss is allowed with other deductions such as home mortgage interest[386] and state taxes[387] as an itemized deduction.[388]

A taxpayer's aggregate itemized deductions, less an overall cutback for high-income taxpayers,[389] reduce her adjusted gross income to derive her taxable income and her resulting tax liability.[390] However, if a taxpayer's applicable standard deduction[391] exceeds her itemized deductions,[392] she will reduce her adjusted gross income by her standard deduction in lieu of her itemized deductions and derive no tax benefit from her casualty loss.[393] Historically, approximately sixty-five to seventy percent of all taxpayers claim the standard deduction rather than itemize their deductions.[394]

Because of the significant reduction of personal casualty losses to derive the deductible amount, generally only significant personal casualty

382. For this purpose, husband and wife are treated as one taxpayer. IRC § 165(h)(4)(B); Regs. § 1.165-7(b)(4)(iii). However, if the married couple file separately and the property is jointly owned each taxpayer must reduce her ½ of the casualty loss by $100. See Internal Revenue Service, Casualties, Disasters, and Thefts, Pub. 547, at 7.

383. IRC § 165(h)(1). For this purpose, the government liberally construes the scope of each casualty and will aggregate events that are closely related in origin (e.g., damage from wind, hail and water from the same storm to a home, automobile, and rental property will be treated as a single casualty). See H.R. Rep. No. 88-749, 1st. Sess. (1963) at 1472; Internal Revenue Service, Casualties, Disasters, and Thefts, Pub. 547, at 6-7.

384. This analysis only includes casualty gains that are not deferred or excluded under Code §§ 1033 or 121, but are recognized. See McCoy, supra note 356, at A-80.

385. IRC § 165(h)(2)(A). For this purpose, adjusted gross income does not include any recognized personal casualty gains. IRC § 165(h)(4)(A).

386. IRC § 163(h)(3) (setting forth requirements for deduction of home mortgage interest).

387. IRC § 164(a) (setting forth the general rule that state taxes are deductible).

388. IRC § 165(h)(4). Adjusted gross income is defined as gross income reduced by certain expenses including trade or business and rental expenses, alimony, certain retirement savings, moving expenses, interest on education loans, higher education expenses, and eligible educator out of pocket expenses. IRC § 62.

389. IRC § 68 (setting forth overall limit on itemized deductions).

390. IRC § 63 (describing the computation to derive taxable income); § 1(describing the tax imposed on taxable income).

391. IRC § 63(c) (describing the basic standard deduction, which amounts vary based upon filing status and are indexed for inflation).

392. IRC § 63(d) (defining itemized deductions).

393. IRC § 63(a), (b) (stating that taxable income is derived by reducing gross income by the greater of itemized deductions or the standard deductions).

394. See Internal Revenue Service, Statistics of Income, Individual Complete Report 2001, Pub. 1304, Table A, Mar. 2004 (setting forth that from 1997-2001 approximately 84 to 85 million taxpayer claimed the standard deduction and approximately 36 to 44 million taxpayers elected to itemize their deductions).

losses ultimately generate any tax benefit.[395] Disaster victims with net personal casualty losses should consider tax planning to minimize adjusted gross income for the tax year they claim the loss.[396] Unfortunately, desperate disaster victims suffering from inadequate cash flow and resources to rebuild their lives might consider selling investments or withdrawing funds from any available source, including tax-deferred retirement funds.[397] These actions are inconsistent with the tax-planning goal of reducing adjusted gross income for a casualty loss year. The withdrawal of retirement funds may increase adjusted gross income, reducing the allowable amount of the casualty loss. Moreover, early withdrawals could subject disaster victims to penalties costing precious dollars at a critical time.[398] With proper planning, disaster victims might be able to time and structure income recognition and withdrawals to minimize tax costs and maximize tax benefits.[399] Proper planning is critical to salvage any tax relief from personal casualty losses.[400] Nevertheless, in many cases, because of the ten percent of adjusted gross income floor, personal casualty losses will not provide any tax benefit.

2. *Business or Investment Casualty Losses*

Alternatively, casualty losses with respect to trade or business[401] or investment property ultimately provide more generous tax benefits than personal casualty losses because they are treated more favorably under the Code.[402] First, allowable casualty losses are not reduced by $100 per casualty

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395. See Internal Revenue Service, Statistics of Income, Individual Complete Report 2001, Pub. 1304, Table 2.1, Mar. 2004 (setting forth that just 97,424 out of 130 million taxpayers claimed personal casualty loss deductions as an itemized deduction in 2001 and 23,434 of whom were taxpayers with no income tax liability); see also Tom Herman, Ask Dow Jones, The San Diego Union-Trib., Aug. 29, 2004, at H6 (noting that many disaster victims effectively receive little or no tax benefit from their personal casualty losses). The Internal Revenue Service provides taxpayers with an excellent workbook for calculating their casualty losses for personal-use property. Internal Revenue Service, Casualty, Disaster, and Theft Loss Workbook, Pub. 584. The workbook contains eighteen schedules for potentially lost household items that will facilitate greatly a disaster victims accounting of her loss. Id. at 4-22.

396. See Annette Nellen, Disaster Relief Provisions: Changes to § 1033 and the Problems that Remain, 22 J. Real Est. Tax'n 158, 167-68 (1995) (suggesting that disaster victims keep their adjusted gross income low by avoiding sales of investment property at a gain and taxable retirement distributions and deferring income, if possible).

397. Id. at 168-69.

398. Id.

399. Id. (suggesting that replacement of withdrawn retirement funds within a specified period of time could avoid income inclusion and penalties).

400. Id. at 167 (reporting that the reduction of casualty losses by ten percent of adjusted gross income prevents many taxpayers from obtaining any tax benefit from their personal casualty loss).

401. Inventory loss in a casualty is generally not deductible as a casualty loss, but rather is automatically reflected in cost of goods sold under Code § 471. See Regs. § 1.165-1(c)(4).

402. The Internal Revenue Service provides taxpayers with an excellent workbook for calculating their casualty losses for business and investment property.

or ten percent of adjusted gross income.[403] Second, if trade or business or investment property is completely destroyed, the casualty loss is the adjusted basis irrespective of the amount of the decline in value.[404] Third, if casualty losses exceed casualty gains, the net loss is a deduction for adjusted gross income and not an itemized deduction.[405] However, if the disaster victim used the property in her capacity as an employee, the casualty loss attributable to the property is characterized as a miscellaneous itemized deduction, which will be deductible only to the extent total miscellaneous itemized deductions exceed two percent of the taxpayer's adjusted gross income.[406] Because of the foregoing differences, casualty loss deductions for business or investment property may provide a greater tax benefit than personal casualty losses.

A final difference between the tax treatment of business and personal casualty losses may not be favorable. A taxpayer must determine business casualty losses for each identifiable piece of property.[407] Alternatively, real property and improvements not held for business or investment purposes are treated as an integral part of one property for purposes of determining the amount of a casualty loss.[408] This difference is most notable in the context of investment real estate, where the difference between characterizing the property as residence versus rental property may cause the item by item casualty loss calculation to result in a smaller overall casualty loss.[409]

Taxpayers with operating losses on investment real estate may be subject to passive loss limitations if they do not materially participate in the trade or business.[410] Personal casualty losses are not subject to these limitations because they arise from personal versus trade or business or rental activities.[411] Notably, the government has provided that casualty losses incurred in a trade or business or rental activity are not subject to the passive loss limitations.[412]

Internal Revenue Service, Business Casualty, Disaster, and Theft Loss Workbook, Pub. 584B.

403. IRC § 165(h)(1), (h)(2) (stating that these reductions are for personal-use property only).

404. Regs. § 1.165-7(b)(1).

405. See IRC § 1231(a)(4)(C).

406. IRC § 67(a), (b)(3) (stating that casualty losses that are itemized deductions that are not due to property held for investment or for personal use is a miscellaneous itemized deduction and is only deduction to the extent the amount exceeds 2% of her adjusted gross income). While this reduces the benefit of this deduction, the reduction is significantly less than the ten percent of adjusted gross reduction for personal casualty losses.

407. Regs. § 1.165-7(b)(2)(i), (b)(3), Ex. 2 (demonstrating that the loss determination is made on an item-by-item basis).

408. Regs. § 1.165-7(b)(2)(ii).

409. See McCoy, supra note 356, at A-76-77 (commenting that the single, identifiable property rule has resulted in taxpayer litigation).

410. These loss limitations are set forth in Code § 469 and are called the passive loss limitations.

411. IRC § 469(c).

412. See Regs. § 1.469-2(d)(2)(xi).

This relief highlights the importance of the threshold characterization of a business loss as a casualty versus operating loss.[413]

While business and investment casualty losses generally are treated more favorably than personal casualty losses, if the casualty occurs in a Presidentially declared major disaster, the treatment could be beneficial for certain disaster victims. Accordingly, the following provisions for the timing of recognition of casualty losses should be reviewed and included in tax planning for victims of Presidentially declared disasters.

3. Presidentially Declared Disaster Losses

a. Timing of Loss Recognition

Generally, taxpayers must deduct casualty losses in the tax year suffered.[414] However, if the casualty losses were incurred in a Presidentially declared disaster and the disaster victim elects, the casualty loss may be deducted in the immediately preceding tax year.[415] Disaster victims may want to make this election to accelerate their receipt of any available refund of tax. If made, the entire casualty loss is treated for all purposes as if it occurred in the prior tax year.[416] Nevertheless, the amount of the casualty loss must be determined on the basis of all the facts existing as of the date the taxpayer claims the loss, including any reimbursements received or reasonably receivable.[417]

The disaster victim makes the election for prior year tax treatment by filing the prior year return, if not already filed, or if filed, an amended return or a refund claim.[418] The filing should specify the date or dates of the disaster and the location (city, town, county, and state) of the damaged property.[419] The disaster victim must make the election by the later of (1) the due date (without extensions) for filing the income tax return for the tax year in which the disaster occurred; or (2) the due date (with extensions) for filing the tax return for the preceding tax year.[420] For most calendar year individual taxpayers, this will be April 15th of the tax year following the disaster.[421] The IRS has granted

413. See Jeffrey A. Unger, Valuation of Real Estate Losses Arising from Natural Disasters: Opportunities for Coordination With FEMA Disaster Loss Verification, 25 J. Real Est. Tax'n 52, 63 (1997) (explaining that the passive loss limitations do not apply to casualty losses).

414. IRC § 165(a); Regs. § 1.165-7(a)(1).

415. IRC § 165(i). This election appears to include losses sustained for damaged inventory. See Internal Revenue Service, Casualties, Disasters, and Thefts, Pub. 547, at 12 (describing the application of Presidentially declared loss provisions for inventories).

416. IRC § 165(i)(2); Regs. § 1.165-11(d).

417. IRC § 165(i)(3); Regs. § 1.165-11(c).

418. Regs. § 1.165-11(e).

419. Id.

420. Id.

421. Internal Revenue Service, Casualties, Disasters, and Thefts, Pub. 547, at 12.

extensions to taxpayers with compelling reasons for missing the deadline.[422] A taxpayer can revoke this election at any time within ninety days of making it if she returns any refund (or credit) received within the later of the end of the revocation period or thirty days of her receipt of the refund.[423] In addition to accelerating loss recognition, casualty losses for victims of Presidentially declared disasters under certain circumstances are more inclusive.

b. Deduction for Casualty Loss Expenses

Victims of Presidentially declared disasters that have been ordered to demolish or relocate their principal residence because the government has rendered it unsafe may recognize any resulting loss as a personal casualty loss.[424] The government must execute this order within 120 days of the President's declaration of the area as a major disaster.[425] A taxpayer may elect to deduct this personal casualty loss in the prior tax year.[426]

4. Application to the Bell Family, Hypothetical Disaster Victims

Unfortunately, the Bells have suffered a $55,000 business casualty loss on their laundromat structure[427] and a $10,000 personal casualty loss[428] on their residential contents. Personal casualty losses must first be offset against any recognized personal casualty gains.[429] Assuming that the Bells acquire a new residence, they will not recognize any personal casualty gains. Therefore, the Bells will have a net personal casualty loss of $10,000, which must be further reduced by $100 and ten percent of the Bells adjusted gross income in 2003.[430] Any remaining personal casualty loss will be allowable as an itemized deduction. Assuming the Bell family has a very low or negative adjusted gross income in 2003 because of uninsured business losses due to the fire, their net personal casualty loss itemized deduction would be no more than $9,900.

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422. See Priv. Ltr. Rul. 9603023 (Oct. 20, 1995) (granting extension to taxpayers who missed deadline by relying on tax professionals inaccurate advice); Priv. Ltr. Rul. 9603024 (Oct. 20, 1995) (same); Priv. Ltr. Rul. 9218022 (Jan. 27, 1992) (granting extension where announcement designating disaster area occurred after the deadline); Priv. Ltr. Rul. 9145009 (July 31, 1981) (granting extension where amount of loss could not be determined by deadline).

423. Regs. § 1.165-11(e).

424. IRC § 165(k).

425. IRC § 165(k)(1); Internal Revenue Service, Casualties, Disasters, and Thefts, Pub. 547, at 12.

426. IRC § 165(k).

427. Business casualty losses for property that is completely destroyed is measured as the adjusted basis in the property (here, $205,000) reduced by the insurance proceeds (here, $150,000) or $55,000.

428. Personal casualty losses are measured as the lesser of the decrease in fair market value (here, approximately $50,000) (the fair market value of the residential contents before the disaster was approximately $50,000 and the fair market value of the property after the fire was $0)) or the adjusted basis (here, approximately $45,000) and further reduced by the insurance proceeds or $35,000. Therefore, the Bells personal casualty loss was $45,000 less $35,000 or $10,000.

429. See IRC § 165(h)(2), (3).

430. See IRC § 165(h)(1), (2)(A).

In addition, the Bells suffered a $55,000 business casualty loss. This business casualty loss would first be offset against any recognized business casualty gains.[431] If the Bells reinvest the insurance proceeds received for their business equipment, they will not have any recognized business casualty gains. If they decide not to purchase any replacement property, their $55,000 business casualty loss would offset their $50,000 recognized business casualty gain resulting in a $5,000 net business casualty loss. Assuming they reinvest in qualifying trade or business replacement property, the Bells have a $55,000 business casualty loss that will provide a business tax deduction, reducing their 2003 adjusted gross income.

These casualty losses were incurred in a Presidentially declared disaster, so the Bells may elect to recognize their deductions in the preceding tax year or 2002.[432] This election could provide the Bells with an accelerated tax benefit. However, upon review of their 2002 tax return timely filed on April 15, 2003, the Bells discover that their 2002 adjusted gross income was $155,000. Accordingly, if they elect to recognize their casualty losses in 2002, they will receive a $55,000 business casualty loss, but will lose their entire personal casualty loss. The Bells would lose any tax benefit from their personal casualty loss because it would be reduced by $10,000 or ten percent of their revised adjusted gross income for 2002 of $100,000, that is, $155,000 less $55,000.[433] Because the election to accelerate the tax losses to the preceding tax year treats all losses resulting from the casualty as 2002 losses, the Bells cannot elect to accelerate their business casualty losses and not their personal casualty losses.[434] Accordingly, the Bells determine that the election is not beneficial because while they would have accelerated their tax benefits from their business casualty loss, they will lose any tax benefits from their personal casualty loss.

The Bells must wait until they file their 2003 tax return in 2004 to receive any available tax benefits.[435] The Bells worry that because the fire forced them to close their business in November and December of 2003, they will have business operating losses and therefore may not receive any tax benefit from their casualty losses. Fortunately, the Code provides relief for taxpayers with businesses that operate at a loss especially when those losses result from a disaster.[436]

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431. See IRC § 1231(a)(4)(C).

432. See IRC § 165(i).

433. See IRC § 165(h)(A)(ii) (describing the reduction of personal casualty losses of ten percent of the taxpayer's adjusted gross income).

434. The Code treats the casualty as having occurred in the preceding tax year, but the loss is measured including all reimbursements anticipated as of the date the taxpayer claims the loss. IRC § 165(i)(2), (3) (providing that the loss is determined as if the casualty causing the loss occurred in the immediate preceding tax year, but that the amount of the loss is determined by including all facts available on the date the loss is claimed).

435. See Tom Herman, Ask Dow Jones, The San Diego Union-Trib., Aug. 22, 2004, at H7 (noting that disaster victims may be able to adjust their withholding or estimated tax payments for the balance of the tax year to accelerate the tax benefits of their losses). Because the California wildfires occurred so late in the tax year, the Bells may only be able to reduce their 4th quarter estimate due on Jan. 15, 2004.

436. See IRC § 172 (setting forth the net operating loss deduction).

D. Net Operating Loss Deduction

If a disaster victim's casualty losses exceed her net income for any tax year, she may be eligible to carry back excess losses as an offset against taxable income for each of three prior tax years.[437] Any losses remaining after the three-year carryback may be carried forward for up to twenty tax years.[438] A taxpayer may elect to waive the entire carryback period with respect to her net operating loss and only carry her losses forward.[439] This option may provide a greater tax benefit for taxpayers whose marginal tax rates will be higher in future as compared to past tax years.

A net operating loss deduction for all casualty losses is unusual for a couple of reasons. First, taxable income is computed for each tax year[440] and deductions from one tax year may not be offset against another tax year without specific statutory authority.[441] Fortunately, one such allowable deduction is the "net operating loss deduction," which generally includes only trade or business deductions exceeding gross income.[442] Notably, the Code provides that for this purpose, personal casualty losses will be treated as trade or business deductions.[443]

Under the provisions for deduction of a net operating loss, a disaster victim suffering casualty losses in excess of her gross income may enjoy an otherwise lost tax benefit.[444] If casualty losses in excess of other income could not be offset against taxable income for another tax year, the taxpayer would not enjoy any tax benefit for these excess losses. Most net operating loss deductions may only be carried back two tax years.[445] The opportunity to carry back the net operating loss to the three prior tax years could generate a tax refund immediately.

Disaster victims with net operating losses must file an amended tax return for the carryback tax year or apply for a quick refund under the Code.[446] The Code provides a "quick refund" process by allowing a taxpayer with a net operating loss to apply for a tentative adjustment of their tax liability for earlier tax years.[447] The Code provides that the government shall examine the

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437. IRC § 163(a).

438. IRC § 172(b)(1)(A)(ii); Regs. § 1.172-6 (setting forth the ordering rule that the loss must be carried forward to the first tax year following the loss year).

439. IRC § 172(b)(3).

440. IRC § 441(a) (setting forth the annual determination of taxable income).

441. See James J. Freeland, et al., Fundamentals of Federal Income Taxation (Foundation Press 13th ed.) at 586, 672-674 (describing the integrity of the taxable year and one exception to its rule the net operating loss deduction); see also Burnet v. Sanford & Brooks Co., 282 U.S. 359, 51 S. Ct. 150 (1931).

442. IRC § 172(a), (d).

443. IRC § 172(d)(4)(C).

444. See for example Smith v. Comm,r, 48 T.C. Memo (CCH) 135 (1984).

445. See IRC § 172(b)(1)(A)(i).

446. Paul R. McDaniel, Martin J. McMahon, Jr., et al., Federal Income Taxation: Cases and Materials 888 n.7 (Found. Press 5th ed. 2004) (describing the alternative quick refund process).

447. Id.

application and issue any refund within a ninety-day period.[448] However, the government's initial examination is provisional and may be adjusted at a later date under the normal audit procedures.[449] This provision provides quick tax relief in the form of a refund of tax dollars previously paid for victims of significant casualty losses, like the Bells.[450]

1. Application to the Bell Family, Hypothetical Disaster Victims

Undoubtedly, 2003 was a difficult year for the Bells. The financial burden of losing a home and business even with insurance coverage can be devastating. The fire turned the Bells' profitable business into ashes. The Bells business income ceased at 3:00 a.m. on October 26, 2003. While they had some insurance coverage of their lost business income, the Bells expect that the Wildcat Canyon Laundromat will generate an operating loss in 2003. In addition to their business operating loss, the Bells have a $55,000 business casualty loss deduction that will increase their business loss. If the Bells business loss combined with their personal casualty loss of approximately $9,900 exceeds their other business and net nonbusiness income they will have a net operating loss in 2003.

Under the Code, the Bells can carry back their 2003 net operating loss deduction to offset any taxable income first in 2000, second in 2001 and finally in 2002.[451] This carryback could generate tax refunds of prior year taxes paid for the Bells freeing up much needed cash by mid-year 2004.[452] Any net operating losses that are not used in 2000, 2001 and 2002 can be carried forward to 2004 through 2023 to offset future taxable income. Because the Bell family has adequate taxable income in 2000, they will be able to generate a refund of taxes from their net operating loss carryback shortly after they file their 2003 tax return as soon as practicable in 2004. While this is not quite as fast as compared to how quickly they would have received their refund if they had amended their 2002 tax returns, the delay should not be significant because the fire occurred so close to the end of the 2003 tax year. The Bells may be motivated by a potentially large cash refund to file their 2003 tax return as early as possible in 2004.

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448. See IRC § 6411(b) (describing the ninety-day period as the later of ninety days after (1) the filing of the application or (2) the last day of the month in which the due date for the tax return (including any granted extensions) falls for filing the return giving rise to the net operating loss).

449. McDaniel, McMahon, Jr., et al., supra note 446, at 888 n.7.

450. The Internal Revenue Service provides taxpayers with an illustrative publication describing the application of net operating losses at its website, www.irs.gov (last visited July 12, 2004). See Internal Revenue Service, Net Operating Losses (NOLs) for Individuals, Estates, and Trusts, Pub. 536.

451. See IRC § 172(b)(1)(F)(i), (ii).

452. Even if the Bells are somehow able to file their 2003 federal income tax return and their application for a tentative carryback and refund adjustment before Apr. 15, 2004, the government has ninety days from Apr. 30, 2004 or through July 29, 2004 (that is, within the later of ninety-days after the last day of the month in which the due date for the tax return (including any granted extensions) generating the net operating loss falls or the filing of the application) to provide a refund. See IRC § 6411(b).

Before they file their 2003 tax return, the Bells will have to understand all of the tax consequences of the wildfires. The Bells are wondering about one of their most significant pre-fire tax deductions, the deduction for interest paid on their home mortgage. The Bells are struggling to continue to make payments on their home mortgage, but wonder about the deductibility of the interest paid now that their home is a pile of ashes.

E. Deductibility of Interest Expense

Under the Code, certain interest expense paid or accrued within the tax year is deductible from gross income.[453] Personal interest, other than trade or business and rental activity interest, investment interest and qualified residence interest, is generally not deductible.[454] Therefore, whether or not interest is deductible depends upon tracing a taxpayer's loan proceeds to the designated use.[455] If loan proceeds can be traced to a use that falls into one of a few specific categories, then the taxpayer may deduct the interest.[456]

When property has been destroyed and it can no longer be used for its original purpose, what is the character of the interest paid on mortgages securing the property?[457] Many disaster victims, like the Bells must address this issue as they struggle through the rebuilding process. Before this Article addresses this question, the Article will discuss the deductibility of interest on SBA disaster loans.

1. Interest Expense on SBA Disaster Loans

a. Business Loans

SBA disaster loans may be made for a variety of purposes. If the loan proceeds are used in the disaster victim's business to rebuild or replenish lost trade or business real or personal property assets including inventory, the disaster victim will be able to deduct the interest on the loan as a trade or business expense.[458] If the disaster victim uses loan proceeds for rebuilding or repurchasing her real and personal property used in a rental activity, the interest paid on the loan will be deductible.[459] This interest is a deduction for adjusted gross income and not an itemized deduction.[460] If the taxpayer's expenses from her trade or business or rental activity exceed her income from the activity, her

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453. See Internal Revenue Service, Casualties, Disaster, and Thefts, Pub. 547, at Introduction.

454. IRC § 163(h).

455. Temp. Regs. § 1.163-8T.

456. Id.; IRC § 163(h).

457. See Rev. Rul. 96-32, 1996-1 C.B. 177 (addressing the question of deductibility of home mortgage interest on two residences destroyed by a tornado and an earthquake).

458. IRC § 163(h)(2)(A) (noting that the trade or business may not be in one's capacity as an employee).

459. IRC §§ 163(h)(2)(C) (including as deductible interest any interest taken into account in computing income or loss from a passive activity), 469(c)(2) (stating that all rental activities are passive activities).

460. See IRC §§ 62(a)(1); 63(d).

losses may be limited under certain circumstances.[461] However, if these losses exceed her other income, she may be able to offset this loss as a net operating deduction against taxable income from prior or subsequent tax years.[462]

b. Personal Loans

Interest paid on loans used for nonbusiness or personal purposes is not generally deductible.[463] If the SBA loan proceeds are traced to pay personal expenses including replacement of clothing, furniture and other household items and expenses, the interest is not deductible.[464] In contrast, an SBA loan to repair or rebuild a disaster victim's residence should generate deductible qualified residence interest.[465]

Qualified residence interest is interest paid during the taxable year on up to $1,000,000 ($500,000 for married persons filing separately) of indebtedness secured by the taxpayer's principal residence and one other residence.[466] The proceeds from the debt must have been used to acquire, construct or substantially improve the secured property.[467] In addition, up to $100,000 ($50,000 for married persons filing separately) of additional indebtedness secured by the residence qualifies even if the loan proceeds are used for purposes other than acquisition, construction or substantial improvements of the property.[468] Thereby, home equity loans can be used for personal expenses converting otherwise nondeductible interest into deductible interest.

Loan fees charged by lenders for services other than the use of money are not deductible.[469] However, if the fees are expressed as a percentage of the loan amount, are for the use or forbearance of the money (e.g., points) and are attributable to a loan to acquire or improve the taxpayer's principal residence, a taxpayer may deduct them in the year paid as qualified residence interest.[470]

Qualified residence interest is an itemized deduction.[471] If a taxpayer's aggregate itemized deductions, after any applicable reduction,[472] are greater than her standard deduction she will reduce her adjusted gross income by her allowable itemized deductions to derive her taxable income.[473] However, if the standard deduction exceeds allowable itemized deductions then a taxpayer will derive no tax benefit from her qualified residence interest. The foregoing discussion addresses the deductibility of interest on a disaster victim's new

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461. See IRC § 469 (setting forth limitations for losses in trades or businesses in which the taxpayer does not materially participate and rental activities).

462. See IRC § 172 (setting forth net operating loss provisions).

463. IRC § 163(h).

464. IRC § 163(h)(2).

465. IRC § 163(h)(3).

466. IRC § 163(h)(3)(A), (3)(B), (4)(A).

467. IRC § 163(h)(3)(B).

468. IRC § 163(h)(3)(C).

469. Rev. Rul. 67-297, 1967-2 C.B. 87.

470. IRC § 461(g)(2).

471. IRC § 62(d), (c), (b).

472. IRC § 68 (providing for a cutback of itemized deduction for certain high-income taxpayers).

473. IRC § 63(a).

loans. However, when a taxpayer owns property that has been destroyed and it can no longer be used for its original purpose, what is the character of the interest paid on mortgages that were secured by the destroyed property.[474]

2. Interest Expense on Existing Home Mortgage Debt

The government answered this question using the following two hypothetical, but painfully realistic scenarios. Assume an earthquake declared a major disaster by the President destroys Ariel's principal residence.[475] Because of a severe shortage of equipment, materials and labor due to the widespread destruction, Ariel was not able to even begin reconstruction of her destroyed home for eighteen months.[476] Sixteen months later, Ariel was able to reoccupy her home as her principal residence.[477] During the reconstruction process, Ariel lived offsite in a rental.[478]

Similarly, Zoe's home is destroyed by a tornado, a Presidentially declared disaster.[479] Two years later, Zoe decides not to rebuild, but rather sells her now vacant lot and buys a new home.[480] During the two-year period before her reinvestment, Zoe lived in a rental property. Ariel and Zoe are faced with many tax issues, including whether or not they could deduct the interest paid on their existing home mortgages during the period of time they no longer resided in their property.

Under a strict definition of principal residence the properties no longer qualify as the taxpayers' principal residences. The Temporary Treasury Regulations underlying Code Section 163 do provide that a taxpayer may treat a residence under construction as a qualified residence for a period up to twenty-four months, but only if the residence becomes the taxpayer's qualified residence when it is ready for occupancy.[481] This provision provides relief during a two-year construction period, before occupancy of the property by the taxpayer as a residence.[482] However, it does not provide relief for the period before construction or for taxpayers, like Zoe, who decide they do not want to rebuild.

Fortunately, the government has ruled that in Ariel's and Zoe's case, the interest paid on their existing home mortgages would continue to qualify as deductible residence interest.[483] In both cases, the government determined that the reoccupation or reinvestment occurred within a "reasonable period of time" and, therefore, the property would continue to be treated as a qualified

474. See Rev. Rul. 96-32, 1996-1 C.B. 177 (addressing the question of deductibility of home mortgage interest on two residences destroyed by a tornado and an earthquake).

475. See Id. (describing this hypothetical, but reality-based fact pattern for the government's analysis and ruling).

476. Id.

477. Id.

478. Id.

479. See Rev. Rul. 96-32, 1996-1 C.B. 177.

480. Id.

481. Temp. Regs. § 1.163-10T(p)(5) (setting forth example of the limitation of this qualifying period).

482. Id.

483. Rev. Rul. 96-32, 1996-1 C.B. 177.

residence during the period.[484] The government also clarified that the same treatment would apply if the property were the taxpayer's second residence or if the destruction had been caused by a disaster not declared to be a major disaster by the President.[485] Accordingly, any disaster victim may deduct interest paid on her mortgage that is secured by her principal or second residence during a reasonable period of time between its destruction and reconstruction or sale.[486]

Disaster victims should note that the construction period stated in the government's example was only sixteen months.[487] The Temporary Treasury Regulations authorize a twenty-four month construction period.[488] If a taxpayer's construction period exceeds twenty-four months, she will want to obtain written documentation explaining the reasons for the extended delays and might want to obtain a ruling from the government on the deductibility of her related interest expense.[489]

Additionally, the government's two-year pre-sale and eighteen month pre-construction periods set forth in the Revenue Ruling should be used as guidance for a reasonable period of time before a taxpayer acts with respect to her damaged property.[490] Taxpayers will want to document in writing the efforts they make to replace their lost home and describe the myriad of issues and roadblocks faced during these periods. When disaster hits, local newspapers and magazines often document the challenges of the rebuilding process.[491]

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484. Id.

485. Id.

486. Id.

487. Id.

488. Temp. Regs. § 1.163-10T(p)(5) (setting forth example of the limitation of this qualifying period).

489. Taxpayers may request a private letter ruling from the government holding that the interest on the indebtedness will be deductible for the pre-occupation period.

490. While this amount of time might seem more than reasonable for a taxpayer to act with respect to damaged property, the rebuilding process for homeowners in a major disaster can be long and herculean. See Mike Freeman, Jennifer Davies and Roger M. Showley, End in Sight: Rebuilding May Be Long Process for Homeowners, The San Diego Union-Trib., Nov. 2, 2003, at A-1, A-11 (noting that because of the overwhelming loss of homes San Diego County would be embarking upon its biggest rebuilding effort in history and that it would be a long (12 to 18 months of planning and construction) and challenging process for residents and the ill-equipped construction industry); Ron Harris, Lack of Workers May Delay Fire Rebuilding, Los Angeles Times, Nov. 9, 2003, at Real Estate (commenting that even if homeowners can find a builder it could be weeks before some areas are safe due to intense heat leaving roads unstable due to oil boiled out of the pavement); Roger M. Showley, Rebuild? A Series of Hurdles Ahead, The San Diego Union-Trib., Nov. 2, 2003, at H8 (reporting that rebuilding a home isn't what it used to be); Fire Notes: Reconstruction Fair to be Held Saturday, The San Diego Union-Trib., Mar. 21, 2004, at B5 (noting that a reconstruction fair would be held bringing together contractors, architects and other construction professionals with fire victims who are beginning to rebuild their homes five months after the fires).

491. See for example Jeanette Steele, Owners are Paid Over Policy Limits, The San Diego Union-Trib., Aug. 29, 2004, at B2, B5 (quoting extended battle of Southern California wildfire victims and insurance companies and quoting California Commissioner of Insurance John Garamendi advising disaster victims to "[f]ight fiercely and never give up").

These independent sources should provide convincing, supporting evidence for delays that may otherwise seem unreasonable.[492]

3. Application to the Bell Family, Hypothetical Disaster Victims

In accordance with the government's ruling, the Bells should be able to deduct the interest paid on their home mortgage after their home was destroyed for a "reasonable period of time" pre-sale or pre-construction.[493] However, the Bells will have to demonstrate that this interim period, that is, the period of time their former residential lot is owned by them and vacant, is reasonable. The government's guidance for what is reasonable provides for a two-year pre-sale, eighteen-month pre-construction and sixteen- and twenty-four-month construction periods.[494]

If the Bells use the entire four-year replacement period authorized under the Code for residential property destroyed by a Presidentially declared disaster area, or through December 31, 2007,[495] to replace their home their interim period may exceed the government's guidance. Notably, the guidance was issued after the Code was amended to extend the replacement period for principal residences destroyed in a Presidentially declared disaster from two to four years.[496] Accordingly, the Bells should make sure they are able to document that their pre-sale, pre-construction and any construction periods are reasonable under the facts and circumstances facing them. If delays persist, they may consider asking the government for a favorable ruling that their interest on their former home is deductible.

In addition to deducting interest paid on the Bells' existing home mortgage, when the Bells incur additional debt to reconstruct or acquire a new residence including any SBA loans, the Bells should be able to deduct as an itemized deduction any interest paid, including points, on qualified residence interest.[497] If the Bells use SBA or other loan proceeds to pay living or other personal expenses, they will not be able to deduct any interest paid during the tax year on these loans. The Bells should consider using any equity in their new principal residence up to $100,000 to secure the indebtedness and have it qualify as home equity indebtedness. If the Bells are able to structure their debt to qualify as home equity indebtedness, any interest paid with respect to such debt should be deductible.

In addition to incurring debt to acquire or construct a new residence, the Bells will likely have to incur debt to rebuild their business. The debt may include SBA business loans and other debt to acquire real and personal business

492. See Jane Clifford, Caught in the Middle, The San Diego Union-Trib., Aug. 28, 2004, at E1 (recounting the Bellante family's struggle to rebuild their home on Wildcat Canyon road).

493. See Rev. Rul. 96-32, 1996-25 I.R.B. 5.

494. Id.; Temp. Regs. § 1.163-10T(p)(5).

495. See IRC § 1033(h)(1)(B) (setting forth four-year replacement period for the replacement of a principal residence by the victim of a Presidentially declared disaster).

496. See id.

497. See IRC §§ 163(h)(3) (providing for the deductibility of interest on qualified acquisition or home equity indebtedness); 461(g)(2) (providing for deductibility of points paid on a taxpayer's principal residence).

property or to provide working capital to support the Bells' new business endeavor. Any interest paid on these loans will be deductible as a trade or business deduction for adjusted gross income in the tax year paid.[498] If the business interest paid creates or increases a net operating loss, the resulting net operating deduction may be carried back two years and forward twenty years to offset taxable income and generate a tax refund of precious dollars.

F. Tax Administration

Disaster victims face numerous challenges as they rebuild their lives. One of the many overwhelming challenges is reconstructing destroyed records. Unfortunately, FEMA and the SBA require that disaster victims must have filed all required federal tax return to qualify for disaster loans and grants.[499] Fortunately, the government works with disaster victims to rebuild their lives by quickly issuing or reissuing tax refunds, extending tax filing and payment deadlines, waiving interest and penalties, offering free tax preparation assistance and providing free copies of previously filed tax returns and other tax documents.[500]

1. Extension of Tax Filing and Payment Deadlines

Under the Code, the government may extend certain tax filing and payment deadlines for a period of up to one year for disaster victims.[501] Taxpayers that are victims of Presidentially declared disasters[502] because their principal residences, principal places of business or record-keeping facilities are located in the designated area are candidates to benefit from these extensions.[503] In addition, the government can add any other party that it determines is affected by the designated disaster.[504]

The extension includes taxpayers' filing of any return, refund claim or Tax Court petition or the payment of any income, employment, estate, excise, or gift taxes.[505] Moreover, the government may extend any deadline for required or permitted actions with respect to pension or employee benefit plans that are

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498. See IRC §§ 163(a); 162(a).

499. Jane Clifford, Caught in the Middle, The San Diego Union-Trib., Aug. 28, 2004, at E1 (recounting the Bellante family's struggle to rebuild their home on Wildcat Canyon Road between the Cleveland National Forest and the Barona Indian reservation).

500. Id.; see also Tom Herman, Ask Dow Jones, The San Diego Union Trib., Aug. 22, 2004, at H-7 (quoting the IRS Commissioner, Mark W. Everson, providing tax relief for Florida disaster victims of Hurricane Charley by extending the tax filing and payment deadlines until Oct. 15, 2004 and abating interest and any late-filing or late-payment penalties).

501. IRC § 7508A(a)(1).

502. IRC §§ 7508A; 1033(h)(3). Taxpayers that are affected by a terroristic or military action (as defined in § 692(c)(2)) are also for these extensions. IRC § 7508A(a).

503. See Internal Revenue Service, Casualties, Disasters and Thefts, Pub. 547, at 13.

504. Id. The IRS has suggested that relief workers that are assisting disaster victims may themselves qualify for relief under this provision. Id.

505. IRC §§ 7508A(a)(1); 7508(a)(1).

affected by a declared disaster or the government's extension of another matter under this provision.[506] Similarly, the government is permitted to extend its own deadlines for making assessments, taking collection action, and bringing suit.[507]

2. *Abatement of Interest and Penalties*

While the extension of filing and payment deadlines for up to one year could give disaster victims time to replace necessary documents and marshal their information and assistance, if interest and penalties on unpaid taxes continued to accrue theses costs might undermine any benefit of the extension forcing disaster victims to ignore the extensions and act to stop the accrual of interest and penalties. Fortunately, the Code provides that the government may also abate the amount of any interest, penalty or additional amount, or addition to the tax with respect to any tax liability for any designated period of extension for up to one year.[508] While the government may extend its own deadlines for deficiency tax assessments, tax collection or filing suits, it may not abate any interest due to disaster victims on their tax overpayments.[509]

3. *Restoring Records and Moving Forward*

Reconstructing tax records is a necessary task for disaster victims. Disaster victims who used a paid preparer to file their current and prior year income tax returns should be able to get copies of their prior year tax filings directly from their preparer.[510] In addition, disaster victims could request copies of information tax returns such as Forms W-2 and 1099 directly from the payer.[511]

Alternatively, taxpayers can request copies or transcripts of tax forms filed during the current calendar year and the three prior calendar years, including information tax returns, by filing Form 4506 or Form 4506-Twith the IRS.[512] The Service should deliver any requested tax return transcripts, which include most line items from the original tax return, within seven to ten workdays of receipt of the request, and any requested copies of tax forms, including W-2 information, within sixty calendar days.[513] Moreover, taxpayers can visit, write or call an IRS office to request tax account information or

506. IRC § 7508(b).

507. Id.; Regs. § 301.7508A-1.

508. IRC § 7508A(a)(2).

509. IRC §§ 7508A(b); 7508(b); 6611(b)(3), (e) (providing that interest on overpayments cannot be disregarded and that tax filings that are timely made under any extension with overpayments shall receive interest on any such overpayment from the date of the overpayment even if the refund is paid within forty-five days after the return is filed).

510. See Internal Revenue Service, Form 4506, Request for Copy of Tax Return, at www.irs.gov (last visited July 12, 2004).

511. See Internal Revenue Service, Form 4506-T, Request for Transcript of Tax Return, at www.irs.gov (last visited July 12, 2004)

512. See supra notes 510 and 511.

496. Id.

Forms 1099, which will include any changes made by the taxpayer or the IRS to original tax returns.[514]

4. Application to the Bell Family, Hypothetical Disaster Victims

On October 28, 2003, the IRS announced that it would extend the deadline for victims of the Southern California wildfires for filing any tax returns, performing any time-sensitive actions and paying any income tax due from October 21 through December 29, 2003 until December 29, 2003.[515] The Service agreed to abate any applicable interest, late payment and filing penalties arising from this extension.[516] In addition, the IRS agreed to consider abating penalties from October 21 through November 7 for affected taxpayers making late Federal employment and excise tax deposits no later than November 7, 2003.[517]

Disaster victims, like the Bells, could also request copies of previously filed tax returns for free and on an expedited basis.[518] To qualify for this relief, disaster victims were advised to put "CA Wildfires" in red ink at the top of their tax returns, requests and payments.[519]

The Bells should not have had any tax returns or tax payments due during the deadline extension period. Therefore, the government's extension likely did not provide any relief for them. The Bells' 2003 tax return and tax liability were due on their original due date of April 15, 2004. Accordingly, the Bells must try somehow to marshal the information necessary to determine their 2003 tax liability. As with any taxpayer, the Bells could extend the filing of their 2003 federal income tax return automatically until August 15, 2004 and with an acceptable reason until October 15, 2004.[520]

The Bells will want to rebuild their personal tax records as soon as possible. To this end, the Bells should request copies of prior year tax returns from their accountant. If they did not use an accountant for prior year tax returns or their accountant does not have adequate historical records, the Bells should contact the government as soon as possible for free and fast copies of their prior year tax returns. In addition, the Bells will have to contact their banks, suppliers and other institutions to recreate their personal and business records for 2003 and the preceding years.

The rebuilding of the Bells' records is critical for them to determine their 2003 tax liability and prepare and file their tax returns in a timely manner. Moreover, as this Article demonstrates, the Bells will have to engage in significant tax planning as they proceed to reestablish their lives. Tax planning requires sound data usually obtained from thick current and historical business and personal tax and accounting files. Victims of a disaster may find

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514. Id.

515. Notice 126, IRS Grants Tax Relief for Victims of California Wildfires, IR-2003-126 (Oct. 28, 2003).

516. Id.

517. Id.

518. Id.

519. Id.

520. See IRC 6801 (setting forth provisions for extensions).

themselves with no information or records. Therefore, recreating information is a critical step to allow the tax planning process to begin.

IV. CONCLUSION

More than one year after surviving their worst nightmare, the Bellante family remains homeless. The Bellantes lost everything in the Cedar fire.[521] After experiencing regular emotional turmoil, they now know some of those things will never be replaced.[522] Yet the Bellantes still have their most precious assets; they have each other and their beloved family homestead.[523] The Bellantes have returned to their land and have set a 6-by-13-foot trailer where their seventy-two year old home once proudly stood.[524] Trying to focus on the future, they are hoping someday to build a new home, but the Bellantes had no insurance.[525] The Bellantes were told again and again that their property was uninsurable because it was too far from a fire station.[526] No one mentioned that they could have sought California-provided homeowner's insurance.[527] Rising above the rubble, the Bellantes are working with Habitat for Humanity to build a new fully-insured home, but there are complications that may douse this dream.[528] Ever optimistic, "[t]he pioneer spirit that drove the first generation of Bellantes west 72 years ago still is very much alive in this family."[529] The Bellantes focus on the little joys each day brings.[530] Fortunately, for the Bellantes and millions of other disaster survivors, life does go on.

This Article demonstrates the complexity, depth and breadth of disaster relief under the Code. Disaster victims must also face state and local income and property tax consequences not addressed in this Article.[531] Understanding

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521. Id.

522. See id. at E1, E7 (reporting that Lori Bellante still has an unsettling fear of loss).

523. See id. at E7 (remembering the Bellantes' eight neighbors who did not escape the inferno).

524. Id.

525. Clifford, supra note 521, at E7.

526. Id

527. Id. (commenting that no one told the Bellantes that if three or more insurance companies refused coverage, they could seek coverage from the state). As a result of the number of uninsured hardship cases emerging from the wildfires, community groups are providing forums to educate themselves about coverage options. See Fire Notes: Ramona, Plans for Workshop on Insurance told The San Diego Union-Trib., Aug. 29, 2004, at B4 (advertising workshop for people who are having trouble finding or keeping homeowner's insurance).

528. Clifford, supra note 521, at E-7 (noting that Habitat for Humanity is concerned about the project because of insurance coverage and the lack of an easement to access their property through the Barona Indian reservation).

529. Id.

530. Id.

531. Many states incorporate federal income tax provisions including income tax disaster relief into their state statutes. Therefore, the coverage of federal disaster tax relief should be very informative for understanding similar state provisions. In addition to income tax, many states assess annual property taxes, which are ad valorem taxes based upon the value of the property. When a disaster damages or destroys property, many states have procedures for having the assessed value reduced, thereby reducing the

and planning for the tax consequences of a disaster are critical pieces of the rebuilding process. Regrettably, disaster victims are often stripped of basic resources and must focus daily on the restoration of shelter, food, clothing and mental health.[532] This Article should serve as some relief for courageous disaster victims[533] facing federal income tax issues that might otherwise seem insurmountable. Unfortunately, the tax consequences of disaster relief and tax disaster relief provisions under the Code are complex and lack transparency. This Article should also serve as a framework for analysis of these provisions and provide a foundation for devising relief from the federal disaster relief provisions themselves.

owner's property taxes. See Annette Nellen, Disaster Relief Provisions: Changes to § 1033 and the Problems that Remain, 22 J. Real Est. Tax'n 158, 166-67 (1995). States may have limited provisions allowing replacement property to retain the same assessed value as the destroyed property despite the replacement property's higher fair market value on the date of the replacement. Id; see Cal. Rev. & Tax Code § 69, 69.3. Disaster victims and their advisors should explore and maximize any state and local disaster relief tax provisions. Roger M. Showley, Rebuild? A Series of Hurdles Ahead, The San Diego Union-Trib., Nov. 2, 2003, at H8 (advising fire victims to contact property tax assessors immediately after damage to their homes to have their property taxes reduced and possibly deferred).

532. Jeanette Steele, After the Fires: Sadness, Frustration, Despair Creep in for Victims, San Diego Union-Trib., Feb. 15, 2004, at B1 (reporting that Melody Morse, a mother of three, who was uninsured, has not received any FEMA grant money, and who relied on credit cards to replace basic furniture, picks up the newspaper every morning looking for fresh leads for disaster victim assistance).

533. When President George W. Bush visited fire victims in early November, he commented "America has got some wonderful citizenry who just refuse to be defeated." Bush Visits Fire Victims, The Orange County Register, Nov. 5, 2003, at A1 (quoting the President while he walked through the devastation of the 2003 Southern California wildfires).