



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, DC 20224

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MEMORANDUM FOR MARY ENGDAHL
TAX SPECIALIST (SB/SE:TEC)

FROM: Lewis J. Fernandez by George Baker
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(Income Tax & Accounting)

SUBJECT: FEDERAL EMERGENCY MANAGEMENT AGENCY (FEMA)
INCOME ITEMS—CERRO GRANDE FIRE

This technical assistance request is in response to your request for assistance dated November 22, 2000, regarding the tax treatment of certain payments that the Federal Emergency Management Agency (FEMA) may make to individuals and businesses in New Mexico that suffered losses due to the Cerro Grande Fire. These payments are authorized by the Cerro Grande Fire Assistance Act (The Act), Pub. L. No. 106-246, 114 Stat. 511. Technical assistance does not relate to a specific case and is not binding on examination or appeals. This document is not to be cited as precedent.

ISSUES:

- Are payments to individuals that are not members of a Pueblo for a claim of lost wages or lost business income includible in the recipient's gross income?
- Are payments to a member of a Pueblo for a claim of lost wages or lost business income includible in gross income?
- Are payments for claims of lost business income includible in the recipient's self-employment income for purposes of the Self-Employment Contributions Act (SECA) tax?
- Are payments for a claim for lost wages includible in the recipient's wages for purposes of employment taxes?
- Are payments to a Pueblo, member of a Pueblo, or a person whose household includes one or more members of a Pueblo for subsistence losses includible in a recipient's gross income?

CONCLUSIONS:

- Payments for a claim of lost wages or lost business income made to a recipient that is not a member of a Pueblo are includible in the recipient's gross income.

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- Generally, payments made to a member of a Pueblo for a claim of lost wages or lost business income are also includible in the recipient's gross income.

Payments made to a member of a Pueblo for a claim of lost business income that would have been derived directly from Pueblo land, however, are not includible in the recipient's gross income.

Payments to a member of a Pueblo for a claim for lost business income from sales of artifacts to tourists on Pueblo lands are includible in the recipient's gross income.

Payments for a claim of lost wages made to a member of a Pueblo are includible in the recipient's gross income.

- Payments for a claim of lost business income that (1) is included in the recipient's gross income, and (2) would not have been made but for the recipient's carrying on of the recipient's trade or business, are includible in a recipient's self-employment income.
- Payments for a claim of lost wages, whether made to a member of a Pueblo or an individual that is not a member of a Pueblo, generally are not includible in a recipient's wages for purposes of employment taxes.
- Payments for subsistence losses are exempt from taxation.

FACTS:

The Cerro Grande fire resulted from a prescribed fire ignited on May 4, 2000, by National Park Service fire personnel at the Bandelier National Monument, New Mexico. The fire ultimately burned more than 47,000 acres in four counties and the Pueblos of San Ildefonso and Santa Clara, and destroyed more than 200 residential structures.

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

The stated purposes of the Act are to compensate victims of the fire for injuries and to provide expeditious consideration and settlement of claims for those injuries. Act § 102(b). The Act created within FEMA an Office of Cerro Grande Fire Claims, and requires that office to administer a program for fully compensating those who have suffered personal injury, property losses, business losses, and financial losses resulting from the fire. The Act limits payments to compensatory damages measured by injuries

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suffered. Act § 104(c)(3). Specifically, the Act permits compensation for “a cost resulting from lost tribal subsistence,” “business loss,” and “lost wages or personal income.” See Act at §§ 104(d)(4)(A)(iv), (d)(4)(B) and (d)(4)(C)(iv), respectively, and § 295.21 of the regulations. It does not permit payments for certain other types of damages, including punitive damages or interest before settlement. An individual seeking compensation under the Act for injuries resulting from the Cerro Grande fire makes a final and conclusive election not to file a claim against the United States for those injuries under chapter 171 of title 28, United States Code (commonly known as the “Federal Tort Claims Act”) or any other provision of law. Act §104(h).

LAW AND ANALYSIS:

Payments to Individuals that are not Members of a Pueblo for Lost Business Income or Wages – Inclusion in Gross Income

The following general analysis, under which the determination of how or whether to tax a payment is controlled by the determination of what the payment substitutes for, is equally applicable to all the payments made by FEMA discussed in this memorandum.

Section 61(a) provides generally that gross income means all income from whatever source derived. Section 1.61-1(a) of the Income Tax Regulations provides that gross income includes income realized in any form. In Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955), 1955-1 C.B. 207, the United States Supreme Court held that the concept of gross income encompassed accessions to wealth, clearly realized, over which taxpayers have complete dominion.

Payments to compensate for lost wages or lost business income due to uncompensated financial losses caused by fire would clearly be income subject to federal tax had the wages been earned or the profits generated in the normal course of the recipient’s trade or business (including the trade or business of being an employee). If, instead, a taxpayer receives damages, or amounts in settlement of claims, for such includible items, the amounts so received are includible in gross income. Hort v. Commissioner, 313 U.S. 28 (1941); Raytheon Production Corp. v. Commissioner, 144 F.2d 110 (1st Cir. 1944). That the payments are received as damages or in settlement of claims is not the question. The pertinent question is “In lieu of what were the damages awarded [or the settlement paid].” Raytheon at 113. Thus, the payments made under this program to compensate claimants for their lost wages or lost business income constitute gross income to the recipients within the meaning of § 61 (except as described below for income of an enrolled member of a pueblo derived directly from land the alienation of which is restricted).

Payments to Members of a Pueblo for Lost Wages or Lost Business Income – General Inclusion in Gross Income

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Payments for lost business income that would have been derived directly from the land

As a general rule, Indians are subject to the same income tax and employment tax obligations as other U.S. citizens, unless a treaty, federal statute, or other applicable law provides otherwise. See Squire v. Capoeman, 351 U.S. 1, 76 S.Ct. 611, 100 L.Ed. 883 (1956). See also Rev. Rul. 67-284, 1967-2 C.B. 55, modified by Rev. Rul. 74-13, 1974-1 C.B. 14. Therefore, except where specifically exempted, a payment to an Indian is taxed in the same manner as a payment to another individual.

The General Allotment Act of 1887, 25 U.S.C. 331 et seq., provides for the allotment of Indian lands to individual members of Indian tribes. It also provides that lands allotted under the Act to Indians and held in trust for them by the U.S. government are exempt from tax. 25 U.S.C. 349. In Squire v. Capoeman, 351 U.S. 1 (1956), the Supreme Court held that the General Allotment Act implicitly exempted trust lands covered by the Act from taxation, and that this tax exemption also applied to income directly derived by individual Indians from allotted lands.

Congress has specifically addressed the Pueblo Indians in other legislation. In particular, the Indian Appropriations Act of 1905, 33 Stat. 1048 provides:

That the lands now held by the various villages or pueblos of Pueblo Indians, or by individual members thereof, within Pueblo reservations or lands, in the territory of New Mexico, and all personal property furnished such Indians by the United States, or used in cultivating such lands, and any cattle and sheep now possessed or that may hereafter be acquired by said Indians shall be free and exempt from taxation of any sort whatsoever, including taxes heretofore levied, if any, until Congress shall otherwise provide.

33 Stat. 1048, 1069. Although the Indian Appropriations Act of 1905 does not per se exempt the income derived from the land, we believe that the principles expressed in Squire v. Capoeman apply to this matter because there is substantial evidence from other legislation addressing the Pueblo Indians that Congress intended them to receive the same protection as other Indians. See New Mexico Enabling Act of June 20, 1910, 36 Stat. 557; Pueblo Lands Act of June 7, 1924, 43 Stat. 636.

Based on the general treatment of Indian lands in the General Allotment Act and restrictions placed on alienation of land by Congress, the Internal Revenue Service has issued rulings clarifying that, where there is a restriction on alienation of Indian lands, income derived from the land is exempt from tax. See Rev. Rul. 67-284, 1967-2 C.B. 55, modified by Rev. Rul. 74-13, 1974-1 C.B. 14. Because the Pueblo Lands Act restricts alienation, these principles would also apply to the Pueblo lands covered by that act. This position is not inconsistent with Revenue Ruling 67-284. The last

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paragraph of that ruling states that “[a]bsent a provision in a treaty or statute to the contrary, income directly derived by a member of an Indian tribe from unallocated Indian tribal lands is subject to Federal income tax.” The provisions of the Indian Allotment Act of 1905 applicable to the Pueblo Indians are such an exception.

The issue then arises as to what constitutes income derived directly from the land. This issue has arisen repeatedly in applying the exemption from taxation under the General Allotment Act. The Service has ruled that income derived directly from the land includes rentals (including crop rentals), royalties, proceeds of sales of the natural resources of such land, income from the sale of crops grown on the land, income from the use of the land for grazing purposes, and proceeds of sales of cattle and other livestock raised on the land. Rev. Rul. 62-16, 1962-1 C.B. 7, modified by Rev. Rul. 74-13, 1974-1 C.B. 14.

Where the income does not stem primarily from exploitation of the land, the income does not qualify as income derived directly from the land. For instance, where the income is derived primarily from capital improvements to the land and/or the Indian’s labor, the income cannot be said to be derived directly from the land. See Critzer v. U.S., 220 Ct. Cl. 43 (1979), cert. denied 444 U.S. 920 (1979) (income from operation of motel on allotted lands is not derived directly from the land). In addition, where the income is derived by an Indian as lessee or permittee under a grazing permit obtained from the tribe, the income is not derived directly from the land and is subject to tax. Holt v. Comm’r., 364 F.2d 38 (8th Cir. 1966), cert. denied, 386 U.S. 931 (1967).

Accordingly, a payment to a member of a Pueblo for a claim of lost business income that would be derived directly from Pueblo lands is exempt from income. Otherwise, a payment to a member of a Pueblo for a claim of lost business income is includible in gross income.

Payments to a Member of a Pueblo for Lost Business Income from Sales of Artifacts

Payments for lost business income of enrolled members of the two Indian pueblos who were selling artifacts to tourists on tribal trust lands ordinarily constitute gross income to the recipients. Although business income of an enrolled member of a pueblo is exempt from tax if the income is derived directly from Pueblo land the alienation of which is restricted, that rule ordinarily does not exempt income from selling of artifacts to tourists on tribal lands. Income from selling artifacts is derived primarily from the Indian’s labor and/or capital improvements to the land and cannot be said to be derived directly from the land.

Payments to a Member of a Pueblo for Lost Wages – Inclusion in Income

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As stated above, Indians generally are subject to the same income tax obligations as other U.S. citizens, unless a treaty, federal statute, or other applicable law provides otherwise. There is no exemption applicable to wages earned by a member of the San Ildefonso or Santa Clara Pueblos. Where the income does not stem primarily from exploitation of the land, the income does not qualify as income derived directly from the land. For instance, wages received for services, even if funded through income derived directly from the land, are not income derived directly from the land. See Dillon v. U.S., 792 F.2d 849, 854 n.4 (9th Cir. 1986), cert. denied 480 U.S. 930 (1987); Hoptowit v. C.I.R., 709 F.2d 564, 566 (9th Cir. 1983). Accordingly, a payment of compensation for lost wages to a member of either tribe is treated like a payment to any another person and is includible in gross income.

Payments for Lost Business Income - Inclusion in Self-Employment Income

Payments made to self-employed individuals that (1) are includible in gross income, and (2) would not have been made but for the individual's carrying on of the individual's trade or business, are earnings from self-employment and are subject to an additional, separate tax under the Self Employment Contributions Act (SECA), relating to social security benefits for the self-employed. See Code sections 1401 - 1403. In Rev. Rul. 91-19, 1991-1 C.B. 186, the Service ruled that amounts paid to self-employed commercial fishing boat operators as compensation for losses due to a corporation's alleged negligence were earnings from self-employment. Although the fishers were unable to fish during the period at issue due to certain alleged negligent acts of the corporation, they were otherwise willing and able to fish. The Service stated that the required nexus between the payment and the carrying on of a trade or business exists if the payment would not have been made but for the individual's carrying on of the trade or business.

Payments to a member of a Pueblo that are includible in gross income will be treated like a payment to any other person. Therefore, to the extent those payments would not have been made but for the recipient's carrying on of the recipient's trade or business, those payments are includible in self-employment income. As discussed above, payments to a member of a Pueblo that are derived directly from the land are not includible in gross income; likewise they are also not includible as self-employment income.

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Payments for Lost Wages - Inclusion in Wages for Employment Tax Purposes

Although a payment from FEMA on account of lost wages is included in the recipient's gross income, the payment (except for a payment to a Federal employee¹) does not constitute "wages" for purposes of the employment tax provisions, because the payment does not constitute remuneration for employment. This is applicable both to recipients that are members of a Pueblo and recipients that are not.

Payment of Compensation for Loss of Subsistence

As a general matter, Indian tribes are not taxable entities under the income tax provisions of the Internal Revenue Code. See Rev. Rul. 67-284, 1967-2, C.B. 55. As noted above, payments made to replace income that would have been derived directly from Pueblo land are not includible in the recipient's gross income. Payment for subsistence losses are on account of items that would have been derived directly from the land. Therefore, a payment of compensation for a subsistence loss as described in the Act and the regulations promulgated thereunder are exempt from income.

We hope this letter is helpful. If you have any further questions, please contact George Baker (regarding gross income issues) at (202) 622-4920 or Stephen Tackney (regarding employment taxes, self-employment income, and Pueblo member income derived directly from the land) at (202) 622-6040.

¹We understand that federal employees were paid by their agencies during the emergency, and are not eligible for payments from FEMA for lost wages. Accordingly, we do not address those types of payments herein.