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Less:		
(i) Excludable retired pay under section (a)(4) as limited by 10 U.S.C. 1403 .....	\$4,500	
(ii) Excludable retired pay under section 105(d) .....	5,200	
(iii) Total .....	9,700	
(iv) Less: Retired pay, not to exceed (iii), waived to receive V.A. compensation "sick pay" exclusion .....	(1,000)	
(v) Net disability and "sick pay" exclusion .....		(8,700)
Net taxable retired pay .....	800	

*Example 6.* D, a member of the uniformed services, retires for physical disability resulting from active service on January 1, 1966, after 35 years of service and with a disability rated at 20 percent. His active duty pay is \$4,000 per year and he attained retirement age prior to retirement. He had an election in effect under the Retired Serviceman's Family Protection Plan to provide his survivor with an annuity and his retired pay is reduced therefor by \$500 per year. He waives \$1,300 of his retired pay in order to receive compensation from the Veterans Administration in like amount. His taxable retired pay for 1966 is \$1,200 computed as follows:

Gross retired pay (75%×\$4,000) .....	\$3,000	
Less: Section 122(a) exclusion .....	(500)	
Reduced retired pay .....	2,500	
Less: V.A. waiver .....	(1,300)	
Adjusted retired pay .....	1,200	
Less:		
(i) Section 104(a)(4) exclusion .....	\$800	
(ii) Less: Retired pay, not to exceed (i), waived to receive V.A. compensation .....	(800)	
(iii) Net disability exclusion .....	0	
Net taxable retired pay .....		1,200

(e) *Principles applicable to the Survivor Benefit Plan.* The principles illustrated by the examples set forth in paragraph (d) of this section apply to an annuity under the Survivor Benefit Plan (10 U.S.C. 1447).

[T.D. 7043, 35 FR 8478, June 2, 1970, as amended by T.D. 7562, 43 FR 38819, Aug. 31, 1978]

**§ 1.123-1 Exclusion of insurance proceeds for reimbursement of certain living expenses.**

(a) *In general.* (1) Gross income does not include insurance proceeds received by an individual on or after January 1, 1969, pursuant to the terms of an insurance contract for indemnifica-

tion of the temporary increase in living expenses resulting from the loss of use or occupancy of his principal residence, or a part thereof, due to damage or destruction by fire, storm, or other casualty. The term "other casualty" has the same meaning assigned to such term under section 165(c)(3). The exclusion also applies in the case of an individual who is denied access to his principal residence by governmental authorities because of the occurrence (or threat of occurrence) of such a casualty. The amount excludable under this section is subject to the limitation set forth in paragraph (b) of this section.

(2) This exclusion applies to amounts received as reimbursement or compensation for the reasonable and necessary increase in living expenses incurred by the insured and members of his household to maintain their customary standard of living during the loss period.

(3) This exclusion does not apply to an insurance recovery for the loss of rental income. Nor does the exclusion apply to any insurance recovery which compensates for the loss of, or damage to, real or personal property. See section 165(c)(3) relating to casualty losses; section 1231 relating to gain on an involuntary conversion of a capital asset held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977); and section 1033 relating to recognition of gain on an involuntary conversion. In the case of property used by an insured partially as a principal residence and partially for other purposes, the exclusion does not apply to the amount of insurance proceeds which compensates for the portion of increased expenses attributable to the nonresidential use of temporary replacement property during the loss period. In the case of denial of access to a principal residence by governmental authority, the exclusion provided by this section does not apply to an insurance recovery received by an individual as reimbursement for living expenses incurred by reason of a governmental condemnation or order not related to a casualty or the threat of a casualty.

(4)(i) Subject to the limitation set forth in paragraph (b), the amount excludable is the amount which is identified by the insurer as being paid exclusively for increased living expenses resulting from the loss of use or occupancy of the principal residence and pursuant to the terms of the insurance contract.

(ii) When a lump-sum insurance settlement includes, but does not specifically identify, compensation for property damage, loss of rental income, and increased living expenses, the amount of such settlement allocable to living expenses shall, in the case of uncontested claims, be that portion of the settlement which bears the same ratio to the total recovery as the amount of claimed increased living expense bears to the total amount of claimed losses and expenses, to the extent not in excess of the coverage limitations specified in the contract for such losses and expenses.

(iii) In the case of a lump-sum settlement involving contested claims, the insured shall establish the amount reasonably allocable to increased living expenses, consistent with the terms of the contract and other facts of the particular case.

(iv) In no event may the amount of a lump-sum settlement which is allocable to increased living expenses exceed the coverage limitation specified in the contract for increased living expenses. Where, however, a coverage limitation is applicable to the total amount payable for increased living expenses and, for example, loss of rental income, the amount of an unitemized settlement which is allocable to increased living expenses may not exceed the portion of the applicable coverage limitation which bears the same ratio to such limitation as the amount of increased living expenses bears to the sum of the amount of such increased living expenses and the amount, if any, of lost rental income.

(5) The portion of any insurance recovery for increased living expenses which exceeds the limitation set forth in paragraph (b) shall be included in gross income under section 61 of the Code.

(b) *Limitation*—(1) *Amount excludable*. The amount excludable under this sec-

tion is limited to amounts received which are not in excess of the amount by which (i) total actual living expenses incurred by the insured and members of his household which result from the loss of use or occupancy of their residence exceed (ii) the total normal living expenses which would have been incurred during the loss period but are not incurred as a result of the loss of use or occupancy of the principal residence. Generally, the excludable amount represents such excess expenses actually incurred by reason of a casualty, or threat thereof, for renting suitable housing and for extraordinary expenses for transportation, food, utilities, and miscellaneous services during the period of repair or replacement of the damaged principal residence or denial of access by governmental authority.

(2) *Actual living expenses*. For purposes of this section, actual living expenses are the reasonable and necessary expenses incurred as a result of the loss of use or occupancy of the principal residence to maintain the insured and members of his household in accordance with their customary standard of living. Actual living expenses must be of such a nature as to qualify as a reimbursable expense under the terms of the applicable insurance contract without regard to monetary limitations upon coverage. Generally, actual living expenses include the cost during the loss period of temporary housing, utilities furnished at the place of temporary housing, meals obtained at restaurants which customarily would have been prepared in the residence, transportation, and other miscellaneous services. To the extent that the loss of use or occupancy of the principal residence results merely in an increase in the amount expended for items of living expenses normally incurred, such as food and transportation, only the increase in such costs shall be considered as actual living expenses in computing the limitation.

(3) *Normal living expenses not incurred*. Normal living expenses consist of the same categories of expenses comprising actual living expenses which would have been incurred but are not incurred as a result of the casualty or

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threat thereof. If the loss of use of the residence results in a decrease in the amount normally expended for a living expense item during the loss period, the item of normal living expense is considered not to have been incurred to the extent of the decrease for purposes of computing the limitation.

(4) *Examples.* The application of this paragraph (b) may be illustrated by the following examples:

*Example 1.* On March 1, 1970, A's principal residence, a dwelling owned by A no part of which was rented to others or used for non-residential purposes, was extensively damaged by fire. The damaged residence was under repair during the entire month of March making it necessary for A and his spouse to obtain temporary lodging and to take their meals at a restaurant. A and his spouse incur expenses of \$200 for lodging at a motel, \$180 for meals which customarily would have been prepared in his residence, and \$25 for commercial laundry service which customarily would have been done by A's wife. A makes (directly or through mortgage insurance), or remains liable for, the required March payment of \$190 on the mortgage note on his residence. The mortgage payment results from a contractual obligation having no causal relationship to the occurrence of the casualty and is not considered as an actual living expense resulting from the loss of use of the residence. A's customary commuting expense of \$40 for bus fares to and from work is decreased by \$20 for the month because of the motel's closer proximity to his place of employment. Other transportation expenses remain stable. Since there has been a decrease in the amount of A's customary bus fares, normal transportation expenses are considered not to have been incurred to the extent of the decrease. Finally, A does not incur customary expenses of \$150 for food obtained for home preparation, \$75 for utilities expenses, and \$10 for laundry cleansers. The limitation upon the excludable amount of an insurance recovery for excess living expenses is \$150, computed as follows:

LIVING EXPENSES			
	Actual re- sulting from cas- ualty	Normal not incurred	Increase (decrease)
Housing .....	\$200.00	.....	\$200.00
Utilities .....	.....	\$75.00	(75.00)
Meals .....	180.00	150.00	30.00
Transportation .....	.....	20.00	(20.00)
Laundry .....	25.00	10.00	150.00
Total .....	405.00	255.00	15.00

*Example 2.* Assume the same facts as in example (1) except that the damaged residence is not owned by A but is rented to him for \$100 per month and that the risk of loss is upon the lessor. Since A would not have incurred the normal rental of \$100 for March, the excludable amount is limited to \$50 (\$150 as in previous example less \$100 normal rent not incurred).

(c) *Principal residence.* Whether or not property is used by the insured taxpayer and members of his household as their principal residence depends upon all the facts and circumstances in each case. For purposes of this section, a principal residence may be a dwelling or an apartment leased to the insured as well as a dwelling or apartment owned by the insured.

[T.D. 7118, 36 FR 10729, June 2, 1971, as amended by T.D. 7728, 45 FR 72650, Nov. 3, 1980]

**§ 1.125-3 Effect of the Family and Medical Leave Act (FMLA) on the operation of cafeteria plans.**

The following questions and answers provide guidance on the effect of the Family and Medical Leave Act (FMLA), 29 U.S.C. 2601 *et seq.*, on the operation of cafeteria plans:

Q-1: May an employee revoke coverage or cease payment of his or her share of group health plan premiums when taking unpaid FMLA, 29 U.S.C. 2601 *et seq.*, leave?

A-1: Yes. An employer must either allow an employee on unpaid FMLA leave to revoke coverage, or continue coverage but allow the employee to discontinue payment of his or her share of the premium for group health plan coverage (including a health flexible spending arrangement (FSA)) under a cafeteria plan for the period of the FMLA leave. See 29 CFR 825.209(e). FMLA does not require that an employer allow an employee to revoke coverage if the employer pays the employee's share of premiums. As discussed in Q&A-3, if the employer continues coverage during an FMLA leave, the employer may recover the employee's share of the premiums when the employee returns to work. FMLA also