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TAX NEWS

Earthquakes, Fires, Floods, and Riots: Selected Federal Income Tax Issues and the Legislative Response

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In October, this column reviewed the basic federal income tax rules that apply to real property damaged or destroyed by recent disasters in California (15 CEB RPLR 308 (Oct. 1992)). In this issue, we discuss some specific federal income tax issues that have arisen because of these disasters. Many of these issues are not only relevant in relationship to recent disasters, but also are likely to be relevant in any future disaster, or in any casualty situation, whether or not disaster-related.

In this column, we also discuss new proposed federal legislation written in response to the October 1991 East Bay firestorm, but with broader application.

A Quick Review

The destruction or involuntary conversion of real property is a taxable disposition or sale of that property under the Internal Revenue Code. *Helvering v William Flaccus Oak Leather Co.* (1941) 313 US 247.

A gain is realized if the insurance proceeds or any other consideration received exceed the taxpayer's adjusted basis in the damaged property. IRC §1001(a). Internal Revenue Code

§1033(a)(2) provides that the taxpayer may elect not to recognize this realized gain if he or she timely purchases replacement property that is "similar or related in service or use" to the damaged property. To the extent the insurance proceeds or other consideration received exceed the cost of the replacement property, gain is still recognized, even if the taxpayer elect deferral. IRC §1033(a)(2)(A). The basis of the new property is its cost minus the realized gain not recognized. IRC §1033(b).

A loss is realized and allowed as a deduction if the taxpayer's adjusted basis exceeds the insurance proceeds or other consideration received, or if the taxpayer does not receive any compensation for damaged property. IRC §165(a). The amount of the loss deduction is (1) the lesser of the decrease in the fair market value of the property, or the adjusted basis of the property, (2) reduced by insurance or other compensation received or recoverable. Reg §1.165-7(b). Nonbusiness casualty losses are further reduced as follows: each loss is deductible only to the extent it exceeds \$100, and net casualty losses are deductible only to the extent they exceed 10 percent of the taxpayer's adjusted gross income. IRC §§165(h)(1) and (2).

Casualty losses are generally deductible for the year in which they are actually sustained. Reg §§1.165-1(d), 1.165-7(a)(1). If, however, a taxpayer suffers a loss in a presidentially declared disaster area, the taxpayer may elect to deduct the loss for the taxable year immediately before the year in which the disaster occurred. IRC §165(i); Reg §1.165-11.

Areas affected by the East Bay firestorm (October 1991), the flooding in southern California (February 1992), the Humboldt County earthquakes (April 1992), and the Los Angeles riots and civil disturbance (April 1992) are all presidentially declared disaster areas. Consequently, losses from these disasters qualify for IRC §165(i) treatment. See Rev Rul 91-69, 1991-2 Cum Bull 38; and Announcement 92-91, 1992-26 Int Rev Bull 35.

Selected Income Tax Issues

Because of the multitude of taxpayers with damaged or destroyed property in California's recently declared disaster areas, a number of federal income tax issues are being openly discussed for the first time by taxpayers and their representatives, the IRS, and members of Congress.

For example, in response to taxpayer inquiry, the IRS issued an information letter concerning the East Bay firestorm on March 19, 1992, discussing some of these issues. Also in March 1992, Representatives Dellums and Stark introduced a bill (HR 5640) that would have amended IRC §1033 to resolve some of these issues. A companion bill, S 3123 (Seymour), which contained the same language as HR 5640, was added to HR 11, a broad tax bill which President Bush vetoed. Since there was little controversy about this issue, it is likely that legislation identical to HR 5640 (with a new bill number) will be introduced early in the next session of Congress.

Home Mortgage Interest

The tax issue that made news headlines in Northern California after the East Bay firestorm concerned the deduction of mortgage interest paid with respect to destroyed property under IRC §163(h).

Enacted as part of the Tax Reform Act of 1986, IRC §163(h) limits the deduction of interest paid by a noncorporate taxpayer to the following circumstances: (1) interest paid or accrued on indebtedness properly allocable to a trade or business; (2) interest paid or accrued on indebtedness properly allocable to an investment (to the extent allowed under IRC §163(d)); (3) any interest taken into account under IRC §469 in computing income or loss from a passive activity; and (4) any qualified residence interest.

"Qualified residence interest" is interest paid or accrued with respect to any "qualified residence." IRC §163(h)(3)(A). A "qualified residence" is a principal residence within the meaning of IRC §1034, or one other residence of the taxpayer selected by the taxpayer and used as a residence (e.g., a vacation home). IRC §163(h)(4)(A).

The issue that arose after the East Bay firestorm was whether a taxpayer could continue to deduct interest paid as qualified residence interest under IRC §163(h)(3) if he or she no longer occupied the property because the residence had been destroyed. The IRS's initial response was that a taxpayer could not deduct this interest, because unimproved land is not considered a qualified residence. The IRS later withdrew from this position after being heavily criticized by taxpayers, local politicians, and the media.

In its March 19, 1992, Information Letter, the IRS stated that

[I]f within a reasonable period of time, a taxpayer rebuilds a destroyed qualified residence and uses the property as a residence as of the time it is ready for occupancy, the taxpayer will continue to be allowed to deduct interest paid on a mortgage on the destroyed residence. If, however, the taxpayer evidences a contrary intent at any time prior to actual use of the property as a residence, the property would not be a qualified residence.

Can a taxpayer who decides not to rebuild, but instead to sell destroyed property, deduct the mortgage interest during this interim period? The IRS's response is that if IRC §1034 applies to the sale (or, if a loss is realized, would have otherwise applied if there had been a gain), the taxpayer's deductions for mortgage interest paid will not be challenged. Internal Revenue Code §1034 allows for the nonrecognition of gain on the sale of a principal residence.

Problems for Taxpayers Who Do Not Reoccupy Property

After a disaster, many taxpayers use their insurance, proceeds to rebuild their damaged or destroyed property; they then reoccupy that property and use it in the same manner as the prior property that had been destroyed. Internal Revenue Code §1033 is available to these taxpayers' because this replacement property is "similar or related, in service or use" to the damaged or destroyed property. (Note that if the destroyed property is a residence, IRC §1033 is available to avoid the recognition of gain, while , IRC §1034 is not. In contrast, either IRC §§1033 or 1034 may be used if property is condemned. IRC §1034(i).)

Many taxpayers choose not to reoccupy their property after a disaster. The economics of rebuilding a new property and also reoccupying that property may not make sense. In addition, the emotional trauma to the taxpayer resulting from the disaster may be an obstacle. Finally, the

amount of time and effort required for the taxpayer to return to a pre disaster position (especially for older taxpayers) may make reoccupying practically impossible.

Although some taxpayers might not reoccupy their property, they may still decide to rebuild their property and then sell or rent it, rather than move back in. If the taxpayer also wants to avoid recognition of gain, these choices may cause problems.

Rebuild and Sell

A taxpayer who rebuilds and then immediately sells the property will likely be forced to recognize any unrealized gain in the property. Although the taxpayer may avoid recognizing the gain resulting from the destruction of the property under IRC §1033, the basis in the rebuilt property is its cost minus the gain not recognized on the involuntary conversion. When the taxpayer sells the rebuilt property, he or she must recognize this previously unrecognized gain unless another nonrecognition-of-gain IRC provision applies.

If the destroyed or damaged property was the taxpayer's residence, he or she may try to use IRC §1034 to avoid recognition of gain on the sale of the rebuilt residence. IRC §1034 applies only to the sale of a "principal residence," and this rebuilt residence may no longer be considered a "principal residence" if the taxpayer has not lived in the property prior to the time it is sold.

Also, some taxpayers may have already purchased another residence, and if the sale of the rebuilt residence happens more than two years after the date on which they purchased their new residence, they are not eligible to use IRC §1034 in any event. Internal Revenue Code §1034 requires that a new principal residence be purchased either within two years before the sale of the prior principal residence or two years after its sale. IRC §1034(a).

Similar problems arise for taxpayers who wish to use IRC §121 to avoid the recognition of gain. Internal Revenue Code §121 provides for a one-time election to exclude up to \$125,000 of gain from the sale of a principal residence for taxpayers who are age 55 or older on the date of the sale. Internal Revenue Code §121 requires that during the five-year period ending on the date of the sale, the residence must be "owned and *used*" as a principal residence for periods aggregating three years or more. IRC §121(a)(2). Again, taxpayers may have problems establishing under IRC §121 that the rebuilt property is a "principal residence." Even if they can establish that the rebuilt property is a "principal residence," they may fail to meet IRC §121 time requirements at the time they sell the rebuilt property.

Rebuild and Rent

Internal Revenue Code §1033 requires that replacement property be "similar or related in service or use." IRC §1033(a)(2). If a taxpayer's principal residence is destroyed and he or she rebuilds and reoccupies a new principal residence, the replacement property will be "similar or related in service or use" to the destroyed property. If, however, the taxpayer rents the rebuilt property to someone else, this property may not be "similar or related in service or use" to the destroyed property. (This may be true even though the rebuilt property physically duplicates the property damaged or destroyed.) Consequently, the taxpayer may be forced to recognize the gain from the involuntary conversion of the destroyed property.

Do Not Rebuild and Sell Land

Some taxpayers may decide after a disaster to sell the land on which their property was located and acquire new property with the proceeds from the sale of their land and insurance instead of rebuilding on the old site. The concern is that the proceeds from the sale of the land would not be considered involuntary conversion proceeds, and gain from the sale would be recognized.

In its March 19, 1992, Information Letter, the IRS provides that gain may be deferred under two alternative provisions of the IRC. If a taxpayer can "show that it was impracticable to rebuild" the property on "its former location (for example, because of new zoning, environmental or building code requirements)" then the "sale proceeds" from the sale of the land are "eligible for nonrecognition under the 'involuntary conversion' rules of [IRC §]1033." Information Letter, p 4.

Alternatively, "[i]f the decision not to rebuild results merely from a taxpayer's preference to live elsewhere (and not because rebuilding on the old location would be impracticable), the taxpayer may nevertheless be entitled to avoid recognition of gain" from the sale of the land "under the 'residence rollover' rule of [IRC §]1034." Information Letter, p 4. The IRS goes on to state that the requirements of §1034 must, of course, still be met. These include "for example-the new residence must be acquired within two years of the sale, and the old property must not have lost its character as the taxpayer's last principal residence." Information Letter, p 4.

Finally, the IRS concludes that §1034 is not available if the property is for "business or investment use." (Presumably, the §1031 like-kind exchange rules could apply instead, although the Information Letter does not address this issue.)

Insurance Proceeds for Personal Property

Internal Revenue Code §1033 requires that replacement property be "similar or related in service or use" to the property destroyed in order for the taxpayer to be eligible for nonrecognition of gain. Does this mean that if the contents of the taxpayer's real property are destroyed, he or she must replace a fork with a fork, or is replacement of a fork with a spoon or any other personal property satisfactory for §1033 purposes? Internal Revenue Code §1033 and IRS regulations and forms are not clear.

Additionally, what about taxpayers who are overinsured as to their personal property and underinsured as to their real property? For example, a taxpayer receives \$100,000 insurance for personal property for which he or she has a potential \$15,000 taxable gain. The taxpayer reinvests only \$50,000 in new personal property. If the taxpayer receives \$300,000 insurance for real property, and takes that money and the windfall from the personal property proceeds and invests the \$350,000 in real property, can he or she avoid recognizing the gain from the involuntary conversion of the personal property?

HR 5640 would have resolved both issues, at least as they apply to personal residences and their contents damaged in a presidentially declared disaster. Specifically, the bill proposed a new IRC §1033(h)(1)(A), which would provide that gains from the receipt of insurance proceeds

for unscheduled personal property in a principal residence would be excluded from taxation. Also, under this new subsection, insurance proceeds for both personal and real property would be treated as a "common fund" (or as a "single item of property"), and could be reinvested in any property that is "similar or related in service or use" to the residence or the contents.

HR 5640 would also have extended the replacement period under IRC §1033 for such property from two years to four years.