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## TAX NEWS

### **Earthquakes, Fires, Floods, and Riots: Federal Income Tax Consequences to Real Property**

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California has been plagued with disasters in the last year or two: earthquakes, fires, floods and riots. After facing the immediate problems connected with these disasters, such as cleanup and physical and/or emotional trauma, clients must then confront the disaster's long-term consequences. One such consequence is the impact of the disaster on the client's federal income taxes.

In this issue, we review the basic federal income tax rules applicable to California real property damaged or destroyed by these recent disasters. In the November issue, we will discuss some of the specific problems that have arisen in connection with California's disasters and what has been learned that will be helpful in dealing with future disasters or casualties. The November column will also discuss proposed new legislation written in response to one of California's disasters.

### **Basic Concepts**

The compulsory or involuntary loss of property, in whole or in part, as a result of destruction, theft, or condemnation is an "involuntary conversion" under the Internal Revenue Code. The involuntary conversion of real property is treated, generally, as a taxable disposition or sale of that property. *Helvering v William Flaccus Oak Leather Co.* (1941) 313 US 247. Consequently, gain or loss is realized for tax purposes and is determined by the difference between the consideration received (i.e., the "amount realized") and the taxpayer's adjusted basis at the time of the conversion. IRC §1001(a).

Although taxpayers may think they have suffered a loss as a result of an involuntary conversion, they may in fact have realized a taxable gain. This may happen, for example, because the taxpayer rolled over the basis from a prior residence or, in the case of income property, lowered the basis by depreciating the property. The first issue to be determined, therefore, is whether or not the taxpayer has indeed realized a loss or a gain.

If the consideration received (typically, insurance proceeds) exceeds adjusted basis, a gain is realized. Because the owner of the involuntarily converted property had little or no control over conversion, IRC §1033 provides special rules to alleviate the inequity of recognizing gain if the converted property is timely replaced with qualifying property.

If the consideration received does not exceed adjusted basis, a loss may be realized. IRC §165 (not §1033) determines the amount, if any, of the realized loss.

### **Realized Gain: IRC §1033**

A realized gain must generally be "recognized." IRC §1001(c). Internal Revenue Code §1033 provides an exception to this rule by allowing gains realized from certain involuntary conversions to be deferred.

When property is involuntarily converted directly into other property that is "similar or related in service or use," nonrecognition of realized gain is mandatory. IRC §1033(a)(1). This type of conversion is rare and is particularly unlikely in the case of the recent California disasters.

The more typical involuntary conversion is when a taxpayer receives, as a result of the conversion, money or other property that is not "similar or related in service or use." In that case, the taxpayer has the option of electing not to recognize gain under IRC §1033(a)(2) if the taxpayer timely "purchases" replacement property that is "similar or related in service or use." To the extent that the amount realized on the conversion exceeds the cost of the replacement property, the taxpayer still recognizes gain even if he or she elected to defer gain. IRC §1033(a)(2)(A).

#### **Example:**

Taxpayer owns real property with an adjusted basis of ; \$5000 that is destroyed by fire. She receives \$17,000 in insurance proceeds and therefore has a realized gain of \$12,000. Subsequently, she invests \$10,000 of her \$17,000 in qualified. replacement property. She may choose to recognize all of the \$12,000 gain or she may elect under IRC §1033(a)(2) to not recognize a portion of it. Under IRC §1033, she must in any event recognize at least \$7,000 of her \$12,000 realized gain (i.e., amount realized from old property (\$17,000), minus the cost of the new property (\$10,000), equals \$7,000) because she only invested \$10,000 in replacement property.

The cost of not recognizing gain under IRC §1033(a)(2) is a lower basis in the replacement property. The basis of the new property is equal to its cost decreased by the amount of realized gain that was not recognized. See IRC §1033(b). A lower basis means reduced depreciation deductions.

Alternatively, if the taxpayer chooses to recognize all of her realized gain and not elect deferral, the basis of the replacement property will be its cost. This probably will result in a greater depreciation deduction.

In the preceding example, if the taxpayer elects to defer her gain, her basis in the replacement property will be \$5000 even though she paid \$10,000 for the property. She must subtract the unrecognized gain (\$5000) from her \$10,000 cost. If the taxpayer instead chose to recognize all of her realized gain, her basis would be \$10,000.

Unlike §1031 like-kind exchanges, the benefit of §1033 deferral is available to all types of property, business or personal. Also, deferral is not limited to conversions of fee interests. Realized gains from the conversion of remainder (Rev Rul 71-567, 1971-2 Cum Bull 309) and leasehold interests (Rev Rul 71-519, 1971-2 Cum Bull 309) may be deferred under §1033.

### **New Property Must Be "Similar or Related in Service or Use"**

To qualify for §1033 deferral, the replacement property must, in general, be "similar or related in service or use" to the property that was converted. Neither the Internal Revenue Code nor the Regulations define this language. (The Regulations provide only three examples of property that is not "similar or related in service or use." See Reg §1.1033(a)-2(c)(9). Consequently, most of the case law and rulings under §1033 pertain to whether or not a taxpayer has obtained proper replacement property.

The Internal Revenue Service initially argued that the replacement property had to be functionally the same as the property converted. Under this "functional" test, the replacement property must have physical characteristics and end uses that are closely similar to the converted property. See Rev Rul 56-347, 1956-2 Cum Bull 517. Strict application of this test was rejected by the Second Circuit Court of Appeals in *Liant Record, Inc. v Commissioner* (2d Cir 1962) 303 F2d 326.

In *Liant Record* the taxpayer took the proceeds from the conversion of an office building and purchased three apartment buildings. The Tax Court held that the buildings were not similar or related in service or use. The Second Circuit reversed and remanded stating that §1033 could apply even though the uses of the buildings differed. According to the court, the focus under §1033 should be whether the taxpayer-owner's relationship to the property has changed. Specifically, if the owner is a lessor, inquiries are to the nature and extent of the lessor's management activity, the amount and kind of services rendered by the lessor to the tenants, and the nature of the business risk connected with the properties.

The IRS now accepts *Liant Record* for the most part and states that it will focus on whether there is "similarity in the relationship of the services or uses which the original and replacement properties have to the taxpayer-owner." Rev Rul 64-237, 1964-2 Cum Bull 319.

The Tax Court, too, accepts *Liant Record* and in *Fred Maloof* (1975) 65 TC 263, 269, elaborated on that case, stating that this standard requires that:

- Reinvestment be made in "substantially similar" property;

- Reinvestment be a "reasonably similar" continuation of the prior commitment of capital and not a departure from it;
- The character of the investment not change, although the replacement property need not duplicate the converted property;
- The entire transaction allow a taxpayer, whose enjoyment of property has been interrupted without his or her consent, to return as close as possible to his or her original position.

Examples of replacements satisfying the "similar or related in service or use" test are:

- Prune, apricot, and walnut orchards replacing truck and cattle farm (*Stevenson v U.S.* (ND Cal 1964) 64-2 USTC ¶9821);
- Leased gas station replacing land and a leased warehouse (Rev Rul 71-41, 1971-1 Cum Bull 223);
- Leased office and warehouse replacing leased light manufacturing plant (*Loco Realty Co. v Commissioner* (8th Cir 1962) 306 F2d 207);
- Improvements made to remaining property to enable continued operation of plant after conversion (Rev Rul 60-69, 1960-1 Cum Bull 294);
- Eighteen acres of unimproved land replacing nine acres of vacant land adjacent to manufacturing plant (*Columbus Die, Tool & Machine Co.* (1952) 11 CCH TCM 1053).

Examples of replacements that do not satisfy the "similar or related in service or use" test are:

- Improved real estate replacing unimproved real estate (Reg §1033(a)-2(c)(9)(i));
- Owner-operated billiard facilities replacing owner-operated bowling facilities (Rev Rul 76-319, 1976-2 Cum Bull 242);
- Interest in real estate investment trust replacing leased commercial building (*Lakritz v U.S.* (ED Wis 1976) 418 F Supp 210);
- Owner-operated motel replacing owner-operated mobile home park (Rev Rul 76-390, 1976-2 Cum Bull 243);
- Owner-operated hotel replacing leased hotel (Rev Rul 70-399, 1970-2 Cum Bull 164).

The above examples illustrate how difficult it is to apply the "similar or related in service or use" test. One can probably conclude from the examples, however, that the test is not satisfied when leased property is replaced with owner-operated property or vice versa, even if the underlying properties are identical.

**“If the insurance proceeds received as a result of damaged or destroyed property do not exceed the property's adjusted basis or if the taxpayer does not receive any compensation for his or her damaged or destroyed property, the taxpayer has realized a “loss.””**

Under IRC §1033(a)(2)(A), a taxpayer may purchase stock "in the acquisition of control" of a corporation owning similar use property and still qualify for §1033 deferral. "Control" is defined as the "ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation." IRC §1033(a)(2)(E)(i). (Note that §1033 makes no provision for replacement through purchase of an interest in a partnership. The Tax Court and the IRS have held that a partner's interest is not similar or related in service or use to the converted property, even though the partnership may own property that is identical. See *M.H.S. Co.*, TC Memo 1976-165,aff'd(6<sup>th</sup> Cir 1978) 575 F2d 1177 and Rev Rul 57-154, 1957-1 Cum Bull 262.)

### **New Property Must Be Replaced Within Specified Period**

IRC §1033(a)(2) requires that the replacement property be purchased within a specified period. The period begins on the date of the conversion and continues until the end of the second year following the close of the first taxable year in which any part of the gain is realized. IRC §1033(a)(2)(B)(i). The IRS can extend the replacement period upon application by the taxpayer. IRC §1033(a)(2)(B)(ii). The taxpayer must show "reasonable cause" for the extension. Reg §1.1033(a)-2(c)(3).

If the taxpayer plans on replacing the property through construction, construction must be completed by the end of the period. Rev Rul 56-543, 1956-2 Cum Bull 521.

### **New Property Must Be Acquired Through Purchase**

Under IRC §1033(a)(2)(A), replacement property must be "purchased." Property will not be considered "purchased" unless its unadjusted basis is its cost to the taxpayer as that term is defined under IRC §1012. Thus, property received by the taxpayer as a gift or in a tax-free exchange is not qualified replacement property.

### **Making the §1033 Election**

Regulation §1.1033(a)-2(c)(2) provides that the election to defer gain under §1033 is deemed made if taxpayers fail to include the full gain on their returns for the year in which any gain is realized, even if they also fail to report the details of the transactions. Any gain that taxpayers expect to recognize is also reported on tax returns for the taxable year(s) in which any part of the gain is realized.

If taxpayers want to recognize all of their realized gain and consequently do not wish to make the election, they report all of this gain in the year realized.

If taxpayers make the election, the statute of limitations on assessments remains open until three years after the IRS is notified that the taxpayer has purchased replacement property or that the taxpayer has not purchased or will not purchase replacement property. IRC §1033(a)(2)(C); Reg §1.1033(a)-2(c)(5).

## **Realized Loss: IRC §165**

If the insurance proceeds received as a result of damaged or destroyed property do not exceed the property's adjusted basis or if the taxpayer does not receive any compensation for his or her damaged or destroyed property, the taxpayer has realized a "loss." Internal Revenue Code §1033 by its terms only applies to "gain" realized from involuntary conversions. Any loss realized must, in general, be recognized or taken at the time of the disposition and not deferred. IRC §1001(c). The issue of replacement property is irrelevant in this case.

Internal Revenue Code §165(a) allows a deduction for "any loss sustained during the taxable year and not compensated for by insurance or otherwise." In the case of an individual, IRC §165(c) limits loss deductions to: "(1) losses incurred in a trade or business; (2) losses incurred in any transaction entered into for profit, though not connected with a trade or business; and (3) except as provided in subsection (h), losses of property not connected with a trade or business or a transaction entered into for profit, if such losses arise from fire, storm, shipwreck or other casualty or from theft." Thus, casualty losses are allowable even if not connected with a trade or business or transaction entered into for profit. Conversely, all losses are deductible to a business whether or not connected with a casualty.

"Casualty" has been defined as the "damage, destruction, or loss of property resulting from an identifiable event that is sudden, unexpected, or unusual." IRS Publication 17, chap 26, *Nonbusiness Casualty and Theft Losses*. Floods, fires, and earthquakes are all "casualties."

In general, the taxpayer must be in the position to prove that the loss experienced was a direct result of the casualty. It is not enough that there be a diminution in value simultaneous with the loss. There must be actual physical damage to the property that is the immediate and direct result of the casualty. See Reg §1.165-7(a)(2)(i) and Rev Rul 66-242, 1966-2 Cum Bull 56.

In order to claim a casualty deduction, the taxpayer must also establish that he or she owned the damaged property at the time of the claimed loss. See *Cleophus L. Kennedy*, TC Memo 1973-15. There is an exception for leased property if the tenant is bound by the lease to restore and replace the damaged premises. Rev Rul 73-41, 1973-1 Cum Bull 74.

### **Amount of Casualty Loss Deduction**

The amount of the casualty loss deduction is determined by the type of property involved and whether or not the taxpayer is an "individual."

#### **Business or Income-Producing Property**

The amount of the deduction for a casualty loss of property used in a trade or business or used in a transaction entered into for profit is limited to the lesser of: (1) the difference between the fair market value of the property immediately before and after the casualty, or (2) the adjusted basis of the property. If, however, the business or income property is totally destroyed and its fair market value before the casualty is less than the adjusted basis, the loss is equal to the adjusted basis. Reg §1.165-7(b)(1). On the other hand, if the property has no basis because it has

been fully depreciated, no deduction is allowed. The amount of the loss so determined is further reduced by any insurance or other compensation. IRC §165(a).

A loss incurred on property used in a trade or business or any transaction entered into for profit must be determined with reference to each single, identifiable item of property damaged or destroyed, even though the properties are integral parts of a whole. Thus, for example, in the case of a casualty occurring with respect to a building and ornamental or fruit trees, the reductions in value must be measured by taking the building and the trees into account separately and determining the losses with respect to each. Reg §1.165-7(b)(2). In sum, a separate loss must be determined for each item, and the separate losses so determined must be combined to determine the amount of the deduction.

### **Personal (Nonbusiness) Property**

The loss deduction for personal property (property that is not used in a trade or business or a transaction entered into for profit, and that is held by an individual) starts out generally the same as above. It is the lesser of the decrease in fair market value, or the adjusted basis of the property. If the property is completely destroyed, however, this rule of lesser of decrease in fair market value or adjusted basis still applies even if basis exceeds fair market value.

Again, the loss deduction must be reduced by insurance or other compensation received or recoverable. (Note that IRC §165(h)(4)(E) provides that a personal casualty loss is deductible only if an individual files a timely insurance claim. This subsection was enacted to reverse the court decision in *Dixon F. Miller*, TC Memo 1980-550, aff'd en banc (6th Cir 1984) 733 F2d 399, which held that the full amount of the loss to an individual taxpayer is still deductible even if the taxpayer did not file an insurance claim.)

The casualty deduction for individuals for nonbusiness losses is 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 adjusted gross income. IRC §165(h)(1), (2).

The \$100 limit applies separately to each casualty, but only once to the entire loss sustained from a particular casualty. (For example, if a taxpayer has a loss from a single casualty over two years, the \$100 limit is applied only once.) Also, the \$100 limit applies to each individual who sustains a loss, even if there is only one item that sustains damage. Reg §1.165-7(b)(4).

The 10 percent limit is applied after application of the \$100 per casualty limit (IRC §165(h)(3)(B)), and only to all net personal casualty losses for the year. IRC §165(h)(2)(A). In other words, this limit does not apply to each casualty but once to all casualties for the taxable year. Also, personal casualty gains reduce personal casualty losses dollar for dollar before the 10 percent of adjusted gross income limit applies. IRC §165(h)(2)(A)(i).

(As discussed above, a "personal casualty gain" is recognized gain (i.e., insurance proceeds exceed adjusted basis) resulting from destroyed or damaged personal property. If a taxpayer has a "personal casualty gain," that means he or she chose to recognize realized gain despite §1033 or failed to meet §1033's requirements.)

In sum, the amount of a personal casualty loss to an individual taxpayer is calculated as follows:

1. Take whichever is smaller: decrease in fair market value or adjusted basis;
2. Subtract insurance proceeds or other compensation, if any;
3. Subtract \$100 per casualty;
4. Combine with other "personal casualty losses," if any, for the same year;
5. Subtract "personal casualty gains," if any, in the same year;
6. Assuming personal casualty losses exceed personal casualty gains or there are no personal casualty gains, subtract 10 percent of adjusted gross income.

**Example:**

T's home decreases in value by \$60,000 as a result of fire damage. He originally paid \$200,000, for the home and received \$50,000 in insurance for the fire damage. His adjusted gross income is \$45,000.

T's casualty loss is calculated as follows:

1. \$60,000 decrease in value is less than the \$200,000 adjusted basis, so it is used.
2. \$60,000 is reduced by the \$50,000 insurance resulting in a \$10,000 loss.
3. \$10,000 is further reduced by the \$100 casualty limit resulting in a \$9,900 "personal casualty loss".
4. If T has no personal casualty gains, the 10 percent adjusted gross income limit further reduces that loss by \$450. T's allowable deduction is \$9,450.

Alternatively, if T had another casualty that year that resulted in a personal casualty gain of \$2000, the loss is reduced by that amount before the 10 percent adjusted gross income limit is applied. In that case, T's allowable deduction is \$9,250. (If T had personal casualty gains of \$9900 or more that year, the 10 percent limit never gets applied because the gains absorb all the loss.)

In the example above concerning the loss to real property and landscaping improvements, in the case of real property used for personal purposes, the improvement, are considered an integral part of the property and are not treated separately. Reg §1.165-7(b)(2)(ii).

**Appraisals**

Generally, the value of the property Immediately before and after the casualty is ascertained by appraisal. Reg §1.165-7(a)(2)(i). The cost of repairs to damaged property can also be acceptable evidence of the amount of loss in value, if the taxpayer can show: (1) the repairs are necessary to restore the property to it, condition before the casualty; (2) the amount spent for repairs is not excessive; (3) the repairs address only the damage suffered from the casualty; and (4) the repairs do not cause the property's value after the casualty to exceed the value before the casualty. Reg §1.165-7(a)(2)(ii).

## **Timing the Deduction**

Casualty losses are generally deductible for the year actually sustained. IRC §165(a); Reg §§1.165-1(d)(1), 1.165-7(a)(1). However, if there is a claim for reimbursement with respect to which there is a reasonable chance of recovery, then, to the extent of such claim, no deduction may be claimed. Reg §1.165-1(d)(2)(i). To the extent there is no claim for reimbursement, the loss is deductible in the year incurred. Reg §1.165-1(d)(2)(ii). If the loss is not deductible in the year sustained because a reasonable chance of recovery exists, such loss can still be deducted in the year in which the claim is adjudicated or settled and no such recovery occurs, or compensation received is less than the amount of the loss.

If a taxpayer deducts a loss in the year sustained because there is at that time no reasonable chance of recovery, and in a later year receives compensation, the taxpayer need not amend his or her prior year's tax return. Instead, the taxpayer includes the recovery in the taxable year in which it was received. Reg §1.165-1(d)(2)(iii).

## **Election as to Disaster Losses**

A taxpayer who suffers a loss attributable to an officially determined disaster may, at the taxpayer's election, deduct that loss for the tax year immediately before the year in which the disaster occurred. IRC §165(i); Reg §1.165-11. To be eligible for this election, the loss must occur in an area determined by the President to warrant assistance as a federal disaster area. If elected, the loss is deemed to have occurred in the taxable year for which the deduction is claimed. It also still must meet the normal requirements for all casualty losses under §165.

## **Character of Involuntary Conversions**

Gains and losses from involuntary conversions of business property are initially subject to the characterization netting rules of IRC §1231.

Section 1231 states that if the recognized losses from such conversions for the taxable year exceed the recognized gains from such conversions for the taxable year, §1231 shall not apply. IRC §1231(a)(4)(C). If §1231 does not apply, then these losses and gains are ordinary because an involuntary conversion is not a "sale" although it is a "disposition." *Helvering v William Flaccus Oak Leather Co.* (1941) 313 US 247. A "sale" of a capital asset is needed to obtain capital gain or capital loss treatment. See IRC §1222. If recognized gains from such conversions equal or exceed such losses, such gains and losses are aggregated with the other §1231 gains and losses. IRC §1231(a)(4)(C).

If after aggregating such gains and losses, the gains exceed the losses, then the gains and losses are capital gains and capital losses (subject to the recapture rules of §§1245, 1250 and 1231(c)). IRC §1231(a)(1). If losses exceed gains, both gains and losses are ordinary. IRC §1231(a)(2). As a result, net losses from involuntary conversions of business property are not subject to the capital loss limitations of IRC §1211.

Personal casualty gains and losses are not subject to the netting rules of IRC §1231. There is, however, a netting rule contained within §165. Section 165(h)(2)(B) provides that, if recognized casualty gains exceed recognized losses in nontrade or business transactions, the

gains and losses are capital gains and capital losses. If losses equal or exceed gains, losses and gains are ordinary because there is, again, no "sale" of a capital asset.

#### **Update on Deferring Estate Taxes Under IRC §6166**

In the August 1992 issue of the Reporter, this column addressed the application of IRC §6166 to real estate holdings. Distinguishing prior authority, a court recently held that a denial of qualification as an active trade or business under IRC §6166 is a matter for which district court review is available. *Gettysburg Nat'l Bank v U.S.* (MD Pa 1992) 92-2 USTC ¶ 60,108. The court further held, in a case of first impression, that real estate leased at a fixed rent to a controlled (more than 50 percent owned) corporation in which the decedent was active, could be aggregated with the stock of the corporation in determining whether closely held business interests exceed 35 percent of adjusted gross estate for deferral purposes. This may be a substantial easing of the requirements for qualification which practitioners should watch closely.