SIFTING THROUGH THE RUBBLE

DISASTER LOSSES & GAINS

Lessons learned from the Oakland Firestorm

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California CPA Education Foundation

Disaster Recovery Workshop
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Welcome to the California CPA Education Foundation’s Disaster Recovery Workshop. This workshop is unique for it was organized to meet the needs of the communities of Los Angeles, Riverside, San Bernardino, San Diego and Ventura who suffered wildfire losses in October, 2003.   I’d like to thank Kurtis Docken and John Dunlevy of the Education Foundation for putting this workshop together, and all the speakers who have volunteered their time and expertise to be here today to help us understand the issues that arise when one losses everything in a wildfire.

George Kehrer, CARE
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Miriam, Sanger,IRS

Please be sure to check out the various resources listed at the California Society of Certified Public Accountants website:
http://www.calcpa.org/californiacpa/newstrends/2003/11.29.html.

FEMA advises your clients to register with them, even if they think they are fully insured. And remember that FEMA and SBA are unable to offer financial assistance to wildfire victims who have not filed past years returns. The IRS is here with us today and will offer assistance to wildfire victims who need to file prior year returns.

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DEDICATION: This presentation is dedicated to the millions of Americans who have had their lives torn asunder by disasters.

The changes to Section 1033 and PLRs and Revenue Rulings issued by the IRS addressing some of the many unanswered questions that were raised when our community was devastated by the Oakland Firestorm are the direct result of the efforts of the Oakland Community. It takes a community to make Congress and Treasury respond to the very urgent needs for reform in the tax law. There are many more areas that need reform, and the two that would provide enormous relief to disaster victims are the following:

1). Tearing down the distinctions under Section 1033 as to what is similar or related in service or use. When disaster strikes, it is complete, involuntary, and victims need to take their capital and reinvest it in trades or business that make sense. A part of the wall has been removed with the enactment of Section 1033 (h)(2) responding to the needs of businesses destroyed by the Oklahoma bombing in 1994.

2). Removing the distinction between trade or business personal property losses and personal losses. Personal property losses must be removed from below the line and brought above the line at original cost and not depreciated basis.

Recent Disasters: No one is ever fully prepared to cope with a disaster. When it hits, it is sudden, devastating, and its victims cope with its impact for years to come. In recent years, this country has been hit hard by a number of large disasters. There was Hurricane Hugo that swept the Carolina coast in 1989, the Loma Prieta earthquake that tumbled Northern California in 1989, the Oakland Berkeley Firestorm of 1991, the worst urban forest fire which destroyed 3,000 homes and took 25 lives, Hurricane Andrew, Hurricane Iniki, the great flood of 1993, where in Missouri alone, 104 counties and two cities were designated as disasters, the firestorm that swept Southern California burning over 200,000 acres in 1993 and destroying over 800 homes, the Northridge Quake of 1994 that jolted the San Fernando Valley awake1, the September, 1999 earthquake that rock the city of Napa in Northern California and in October ,2003 the Wildfires that swept over counties of Los Angeles, Riverside, San Bernardino, San Diego, and Ventura, destroying over 4,800 homes and affecting 1100 square miles.

CALIFORNIA SOCIETY OF CPA WEBSITE: The California Society of Certified Public Accountants web site has a number of resources available to Wildfire victims and their advisors. The web site is located at

Measuring the loss: While IRS Publication 547, "Nonbusiness disasters, Casualties, and Thefts" and Internal Revenue Code Section 165 all tell us that the measure of the loss sustained in a disaster is the lesser of its adjusted basis or the decline in its fair market value, that determination is often very difficult to make[1].

Regulation section 1.165-7(2) tells us that in determining the amount of deductible loss, taxpayers must ascertain the fair market value of the property immediately before and after the disaster. Publication 547 cautions taxpayers to use experienced and reliable appraisers who have knowledge of sales of comparable property, of the condition of the area, and one who is familiar with the property before and after the casualty. The appraiser must be competent to recognize the effects of any general market decline affecting the undamaged as well as damaged property, which may occur simultaneously with the casualty, to limit the actual loss to damage to the property[2]. A second standard has been adopted by the regulations, "the cost of repairs" method[3]. However, the

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[1] See IRS Publication 2194, 2003 Disaster Losses Kit for Individuals. It includes copies of Publication 3932, Casualty Losses- document list, Form 4506, Request for Copy of Tax Form, Publication 584, Casualty, Disaster, and Theft Loss Workbook, Publication 547,Casualties, Disasters and Thefts, Form 4868 and Instructions, Casualties and Thefts, Publication 551, Basis of Assets, Publication 536, Net Operating Losses (NOLs) for Individuals, Estates and Trust, Form 1040X and Instructions, Amended U.S. Individual Income Tax Return, Form 8822 Change of Address. See also Publication 584B Business Casualty, Disaster and Theft Loss Workbook.

[2] Rev Rul 66-49 for IRS guidelines for all persons making appraisals of donated property; see also Keligian, David L, "Appraisal Issues Now Require Greater Attention for Tax Planning To Be Effective", 80 J. Taxation, No.2, 98.

[3] Regl § 1.165-7(a)(2)(ii), see DiPlacido, TC Memo 1993-169; Lamphere, 70 TC 391 (1978), see also RV BAker, 37 TCM 1556 where undisputed testimony as to the

taxpayer has the burden to prove that the repairs are necessary to restore the property to its condition just before the fire, that the amount spent is not EXCESSIVE, that the repairs are limited only to casualty related damage, and that the value of the property after the repairs does not as a result of the repairs exceed the value of the property immediately before the casualty[4]. If disaster victims fail to obtain a competent appraisal and rely solely on this second method, the IRS and some courts are allowing only the actual amounts spent to repair as the casualty loss, even in cases where it is clear that the damage was sustained by the courts own admission, and the repairs were not done because the taxpayers were unable to afford the repair[5]. Neither ***Lamphere*** nor ***DiPlacido*** obtained any appraisal of the decline in FMV of their properties after the disaster. Lamphere's loss was limited to the actual amounts expended, while DiPlacido's loss was increased by some amount determined by the courts to be a more correct determination of his disaster loss. Why the difference? The quality of the evidence submitted by each taxpayer.

Evidence

Taxpayers have the burden of proving the amount of their loss. ***Bruhns***[6] failed to prove that his loss exceeded the amount of insurance received for flood damage and failed to provide evidence of the decline in FMV or the adjusted basis of his home damaged. ***Lutz***[7] was not entitled to the complete casualty loss since he failed to establish the amount spent on repairs. But where the taxpayer provides competent evidence, the loss is sustained. ***Smithgall***[8] was entitled to a casualty loss deduction for clean up and repair expense as well as for the decrease in FMV of his home. ***Baker***[9] was allowed as a casualty loss the estimated cost of his labor in clearing land after hurricane damage, where the cost did not exceed the limitation on casualty losses.

The courts have held that the sales price shortly after may be a better indicator of the value after, notwithstanding the

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FMV before and after a flood as to adjusted basis of inherited property was sufficient to establish that they were entitled to a casualty loss deduction.

[4] Rev Rul 66-303, cost of restoring landscaping to original condition may be indicative of the decrease in fair market value; Harmon, 13 TC 373 (Acq.); L.F.Ford, 33 TCM 496

[5] Lamphere 70 TC 391; DiPlacido, TC Memo 1993-169

[6] 61 TCM 2032

[7] 79-1 USTC ¶ 9258; see also Hagerty TC Memo 1975-66 where the cost of repairs was not a proper measure because the repair work didn't restore the taxpayer's residence to its pre-fire condition, and Bagnol TC Memo 1978-240 where loss not allowed because repairs were never made.

[8] 81-1 USTC ¶ 9121

[9] 60TCM 1077

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presence of an appraisal that indicated a greater loss[10]. **Woods** suffered damage to his residence from an unprecedented drought in the area. Nine months later he sold his home for $1,000 less than the appraised value of his home just before the drought. On his tax return, he claimed a $7,000 loss based upon an appraisal that valued his home for use as a single family residence, though the land was zoned for multiple units, and the land and damaged home were sold to a developer who eventually built a multiunit building on the land. The court held that the appraiser had the duty to value the land based upon its possible multiunit use, and held that the evidence didn't sustain a loss of $7,000. The courts allowed a $1,000 loss.

REPAIR COST DIFFERENT FROM APPRAISAL OF THE DECLINE IN FMV- The courts in ***Conner***[11] held that the decline in FMV of his home and not the cost of restoration was to be used to determine the amount deductible as a casualty loss. The decline in FMV as $93,054, and the cost to repair was $66,395. The court found the taxpayer's evidence of the decline in FMV to be credible and noted that it had addressed the question as to the amount of a deductible loss where the actual cost to repair was less than the decline in FMV. In **Alcoma Association**[12] a hurricane damaged a citrus grove and there was no way to restore the grove to its pre-casualty condition. The court granted a loss equal to the decline in FMV because it held that it would not be an uncommon situation where the restoration of the property might be impossible, inadvisable, yet the loss had been sustained[13]. The court is so holding noted that where the cost to repair exceed the decline in FMV the Commissioner would use his regulations under Section 165 to limit the loss to the decline in FMV. And where the cost to repair are less than the decline in FMV and the taxpayer offers no substantive evidence that his property has not been restored to its pre-casualty condition, the courts have held that appraisals detailing a larger decline in value is not the most reliable benchmark for determining the loss[14]. Pfalzgraf's home was damaged in a fire, and the insurance proceeds covered the cost of the repairs. He took a casualty loss for the excess of the decline in FMV over the cost to repair. The court in disallowing the excess loss noted that the appraisal factored in non-casualty related items

[10] Woods,19TCM388 (1960); Ferst, 129 F.Supp. 606 (M.D. Ga. 1955)

[11] 71-1 USTC ¶ 9271

[12] 57-1 USTC ¶ 9203

[13] Contrast this with the decision in Lamphere

[14] Keith 52 TC 41 (1969) A. 1970; Clapp 321 F.2d 12 (C.A. 9,1963), aff'g 36 TC 905 (1961); Squirt Co, 51 TC 543, (1969); Clarence A. Peterson, 30 TC 660 (1958); Pfalzagraf, 67 TC 784, A. 1977-2 CB2; Kalbfleisch, TC Memo 1991-61.

such as aggravation, lack of buyers for a partially damaged residence, contractor profit margin, sales costs, real estate taxes, as well as a 25% profit margin to compensate the buyer for his time to repair the building. The court concluded that while they sympathized with the emotional distress.... they did not know how to value aggravation and saw no need to, since it is surely not part of a casualty loss.

COST TO REPAIR EXCEED THE DECLINE IN FMV

The court in ***Hubinger*** [15] disallowed the loss because the taxpayer was unable to prove that his adjusted basis in the property damaged exceeded the insurance proceeds received it held that the nature of the repairs were capital in nature since they were not able to restore the commercial building to its condition just prior to the disaster. In its decision the court looked at whether these excess costs would otherwise be deductible. It concluded that one had to look at the significance of the expenditure relative to income holding that an item in relation to income may be so insignificant that it would be absurd to require capitalization even though technically it would be considered an improvement and not a repair. Using this standard, the court held the excess costs would otherwise be non-deductible because the court did not believe that Congress intended to allow as charges against income the revenues the cost of restoring major parts of an income-producing property where the restoration is of such a character as to be useful over a long period of time.

Where the amount of insurance collected exceeded the depreciated basis of the building destroyed, amounts spent to reconstruct which exceeded the insurance recovery were held not to be a casualty loss[16]. In ***Belcher*** [17] the court disallowed the casualty loss in excess of the cost basis of the property lost, and in **Drew** [18] where the loss exceeded the adjusted basis of the property damaged.

BUYER RESISTENCE/ MARKET STIGMA

Under the regulations of 165 taxpayers are precluded from taking a casualty loss due to temporary declines in market value due to buyer resistance. In ***Revenue Ruling*** **66-242** the IRS discounted the appraisal done by the taxpayer because it took into account not only the actual physical damage sustained, but

[15] 13 BTA 960
[16] Pelican Bay Lumber Co 9 BTA 1024
[17] 60-2 USTC ¶ 9733
[18] 31 TCM 143

also a decline in value due to "economic obsolescence attributable to buyer resistance". The regulations limit the deductible loss to actual value, noting that the loss must be more than a mere diminution in value demonstrable solely by some economic concept. In the absence of corroborating market data shown by bona fide purchases and sales of the decline, “potential buyer resistance is just speculative”. The courts have generally rejected losses due to buyer resistance. ***Kendall*** [19] tried to take a deduction for the difference between what he thought his property was worth, and what it sold for. The court held that even if it would agree that the loss occurred in fair market value, this loss was not the result of physical damage caused by the storm, but from fear on the buyer's part. While taxpayers find this one hard to swallow, the courts are generally unwilling to give them the deduction for this type of loss. Additionally many taxpayers erroneously believe that the measure of their loss is that difference in fair market value before and after the disaster. They forget that the overall limitation on the loss is their adjusted basis in the property. Where a personal residence has been placed into service, and its fair market value before the disaster is less than its adjusted basis, that FMV becomes the new basis for determining the limitation on the loss.

Other cases where courts have ruled against taxpayers:
Pulvers [20] where taxpayer attempted to take a loss for the decline in FMV of property because of landslides in the neighborhood, and ***Kamanski*** [21] where part of the loss from landslide damage to his home was due to buyer resistance and the unwillingness of financial institutions to make loans in that area.[22] Kamanski suffered minor damage to his house in a landslide, which he did not repair. He tried to sell his home, but no one wanted to purchase it, so he just walked away from it in 1966 and let the trust deed holders take possession of it. They tried unsuccessfully to sell it and couldn't, so they rented it out. At the time of the trial, the home was still unsold and still rented out. The court agreed with the IRS that the taxpayer's loss was limited to the physical damage, since buyer's resistance is generally temporary in nature.

CASUALTY LOSS ATTRIBUABLE TO PERMANENT DECLINE IN LAND VALUE
In order for land to sustain a casualty loss, the taxpayer must demonstrate that it incurred a permanent decline in value. The courts did sustain a loss in ***Finkbohner***[23] for a loss incurred

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[19] 17 T.C.M.809 (1958)
[20] 48 TC 245 (1967)
[21] 29 TCM 1702 (1970)
[22] See also Ford, 33 TCM 496, (1974), Benner 36 TCM 682 (1977)
[23] 788 F.2d 723, (11th Cir,1986)

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not only for physical damage from flooding but also for "permanent buyer resistance" where there was extensive damage to 7 of the 12 neighboring homes, all of which had to be demolished, and where the vacant lots were acquired to establish permanent open space.

The court in ***Beyer***[24] denied the taxpayer a casualty loss deduction for a permanent decline in FMV because their expert using faulty comparisons, failed to establish that erosion of sand from heavy rains diminished the value of the beach front property. A reading of Beyer conveys to us what facts and evidence the courts require to support a permanent decline in the value of land. Severe storms in 1983 swept away a major portion of Beyer's beach front property, which he repaired for $66,293, though he claimed a loss of $2,076,239 on his return. The court in agreeing with the Commissioner disallowed the loss because the taxpayer failed to sustain his burden of proof that the land had suffered a permanent decline in value. It didn't help that the IRS's appraiser presented market data that proved that the selling price of a neighboring home had increased between the period of time prior to and after the storms. In arriving at its decision the court recognized that it is generally accepted that the amount of the loss is represented by the difference in FMV before and after the disaster [25]. However the courts have also recognized that competent appraisal is one of the methods of proving the value of the loss, and have recognized that the loss may also be proved by the cost to repair, though if work done also includes capital improvements, such improvements are not part of the loss. What was fatal in ***Beyer*** was that his expert failed to prove what the amount of the decline in value was, and used faulty comparisons to arrive at his appraised decline in FMV.

Use of Disaster Loan Appraisals to Establish Amount of Loss

Section 912(a) of the Taxpayer Relief Act of 1997 added IRC §165(i)(4)which provides that taxpayers can use alternate types of acceptable appraisals to establish the amount of the disaster loss. This section was enacted in response to concerns raised after the Northridge Earthquakes of 1994. The IRS is to prescribe regulations or other guidelines under which an appraisal that is made for purposes of getting a loan of federal funds or a loan guarantee from the federal government as a result of a Presidentially declared disaster may be used to establish the amount of the disaster loss. The new provision permits taxpayers to use the appraisal made for

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[24] TC Memo 1993-313

[25] Helvering v Owens, 39-1 USTC ¶ 9229; Lamphere v Comm, 70 TC 391

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purposes of getting a federal loan or guarantee to establish the amount deductible as a disaster loss.

Indirectly sustained losses

Generally indirectly sustained losses are not deductible, although the courts in ***Stowers*** [26] allowed a loss where there was no access to the road to the taxpayer's residence because of a landslide and in ***Marx*** [27] the courts sustained a casualty loss where a roofer's negligent work caused a single isolated leak to multiply into 15 massive leaks.

Converted property

For property that has been converted from personal to business, the regulations under Section 1.165-7(a)(5) limits the amount of the loss to the fair market value of the property on the date of conversion, even if this is less than the adjusted basis of the property at the time of the conversion.

EXAMPLE:

Taxpayers purchases a home for $360,000 in January 1992, and in September,1992 place it on the market because of a job related move. They are unable to sell it because of general market conditions and the economy for $360,000. The property is appraised at $300,000 and they get an offer for $300,000 but reject it, and rent it out instead. Their adjusted basis for purposes of Section 165, 167 and 168 depreciation is $300,000. The home is destroyed in the Northridge Quake of 1994. The appraisal made after the earthquake states that the property is a total loss including the land and calculates the loss at $300,000. Their loss is limited to adjusted basis, $300,000 minus depreciation taken. The other $50,000 in basis just vanishes.

Treatment of demolition costs, appraisal costs, costs to document loss

Items that are treated as part of the casualty loss include incurred costs of repair, amounts expended to remove debris and other clean up costs[28], as well as expenses incurred to recover reimbursement or compensation of loss. While such costs are evidence of the loss sustained, they do not take the place of an appraisal. These costs are of the nature of a replacement of the part of the property that was damaged and are capitalized and added to the basis of the property. The costs

[26] 169 F. Supp 246 (S.D.Miss, 1958)
[27] Marx TC Meno 1991-598
[28] Revenue Ruling 71-161

of photographs, and appraisals are not part of the casualty loss, but are considered expenses incurred to determine a tax liability and are deductible as Section 212 expenses, subject to the 2% rule on itemized deductions.

Generally costs incurred to recover reimbursement are netted against the settlement and are not deductible. However while the court in ***Spectre*** [29] denied a deduction for an unsubstantiated decline in value in excess of an insurance recovery, it did allowed a "casualty loss" deduction for legal fees and amounts paid to an adjuster incurred in connection with litigation. In this case, the court first applied the insurance proceeds against the "claimed loss", and limited the amount of the loss to the insurance proceeds since the taxpayer failed to substantiate a loss in excess of the insurance proceeds. The additional costs incurred for legal expenses were taken as an additional casualty loss and not as a miscellaneous itemized deduction. In ***Marx ®***[30] the courts did not allow a deduction for legal expenses incurred to pursue breach of contract warranty against the maintenance company that caused the leaks in the roof. Where the taxpayer is unsuccessful in his litigation attempt, these expenses are not deductible unless incurred in a trade or business[31].

Basis adjustments

Basis is reduced by the amount of the **allowable** loss deduction, any insurance proceeds received (minus expenses incurred to settle), or other reimbursement received such as:

-Forgiven part of a Federal Disaster loan under the Disaster relief and Emergency Assistance Act

-Repayment/ costs of repairs paid by persons who lease the taxpayer's property

-Court awards for damage for a casualty, reduced by lawyers fees, and other settlement expenses

-Repairs, restoration, cleanup services provided by

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29 25 TCM 519 (1966); Jeffers 12 TCM 534 (1953) where legal fees incurred in connection with obtaining an insurance recovery reduced the amount of insurance recovery to offset against the casualty loss; Ander, 47 TC 592; consider also the applicability of the origin of claim doctrine in such a case.

30 IBID

31 Tarsey, 56 TC 553, 1971; Ticket Office Equipment Co, 20 TC 272, aff'd 213 F.2d 318 (C.A. 2,1954)

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relief agencies [32]

Gifts from relatives don't reduce the amount of the allowable loss if there is no limitation on how the money is to be spent [33]. FEMA grants, other grants, gifts, and other payments received by a disaster victim are considered reimbursement only if they are specifically designated to repair or replace property. If there are no conditions on how the money is be used, it is not considered a reimbursement[34]. If there is no adjusted basis at the time of the loss, the amount is considered income[35].

Amounts required to be capitalized into basis include amounts paid to replace or restore the damaged property that would be considered capital expenditures including debris removal and demolition costs. There is no ordinary income recapture of the previously claimed casualty loss at the time the property is sold[36]. Food, medical supplies, and other forms of subsistence do not reduce the amount of the loss, and are not considered taxable income[37].

Accounting for disaster losses incurred in a trade or business
Taxpayer suffers damage to his commercial building in the Loma Prieta earthquake of 1989. The decline in fair market value is $50,000, he incurs $500 in legal fees to settle with his insurance company, which paid him $ 7,000, and he spends $10,000 to remove debris and $40,000 to repair the property. Computation of adjusted basis of the property after the casualty loss, and after repair:

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[32] RR 71-160, 71-161, 73-408,74-206; see also Durden, 3TC 1 (1944) where value of driveway laid by quarry offset the amount of the allowable loss
[33] Revenue Ruling 64-329
[34] Publication 547, IBID, Rev Rul 64-329, Rev Rul 71-160 IBID.
[35] Rev Rul 76-509 1976-2 CB 254 where income from the cancelled portion of an emergency FHA loan was deemed SE income. However see the discussion under Section 1033 where the “gain realized” may be deferred. See also Rev Rul 2003-12 which excludes from income relief grants intended to pay or reimburse medical, housing or transportation.
[36] Cox 38 AFTR 2d ¶ 5351
[37] IRS Publication 547

Adjusted basis before the disaster		$250,000
minus allowable casualty loss:		
appraised loss	50,0000	
less insurance recovery	(7,000)	
legal expenses	500	
debris removal	10,000	
allowable loss		(53,500)
ADJUSTED BASIS AFTER THE DISASTER:		196,500
cost of repairs		50,000
ADJUSTED BASIS AFTER CLEAN UP AND REPAIR		$246,500

Other recoveries and compensation
Insurance recovery need not be allocated in any specific manner. In ***Ticket Office Equipment Co.***[38] the court held that the insurance recovery did not need to be allocated in any specific manner. Here the company lost personal property including inventory, and spent the money on other items and took a loss on the inventory. Court held this to be ok. Query--What happens if taxpayer receives reimbursement for an event that does not give rise to a deduction, such as an award for faulty construction? To the extent that there is basis, the reimbursement would reduce basis and if the recovery were greater than basis, it would appear to be income, unless the money could be considered to be received for the involuntary conversion of the property and subject to the rules under Section 1033.

Living expenses as part of the casualty loss
It is clear that money spent for temporary accommodations for the period of time that the home is notable to be occupied are personal in nature and may not be deducted as part of the casualty loss [39].

Different rules for personal and business disaster losses
Disaster losses suffered by businesses and owners of real property held for use in a trade or business or for investment are accorded a different tax treatment than homeowners who lose

[38] 20TC 272 (1953) acq. 1953-2 CB 6

[39] Rev Rul 59-398, Millsap 46 TC 751 (1966)

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their home and everything in it. Under 1.165-7(b) the measure of a "business loss" is the lesser of its adjusted basis or its decline in fair market value. However, if the fair market value prior to the disaster loss is less than the adjusted basis, it is considered the measure of the loss[40]. For uninsured businesses this often results in a large economic loss, but only a small tax loss, if any, because the adjusted basis of most of their assets have been expensed or fully depreciated. Where real property used in a trade or business or for investment is damaged or destroyed, the loss is limited to the adjusted basis in the realty[41]. For personal use assets no such allocation is required between land and realty[42].

Special treatment for losses of inventory Losses of inventory are generally not taken as a casualty loss, but are reflected as an adjustment to the cost of goods sold. If the loss is reported separately, the IRS requires that the taxpayer make an offsetting adjustment to either opening inventory or purchases[43].

Limitations on personal losses
While an above-the-line deduction is allowed for losses incurred in a trade or business, personal, non-business losses are allowed only if they fit within the purview of certain limited types of losses allowed under Section 165. Section 165(c)(3) allows a deduction for losses resulting from a "fire, storm, shipwreck or other casualty, or theft." Publication 547, ***Non-Business Disaster, Casualties and Thefts***, defines "casualty" as the complete or partial destruction or loss of property resulting from an identifiable event that is "...sudden, unexpected or unusual in nature." Destruction caused by progressive deterioration of property, such as termite or moth damage is not accorded casualty loss treatment.

The Supreme Court in ***Helvering V Owens*** [44] set the standard for limiting the losses of nonbusiness property to the lesser of its adjusted basis or depreciated value, even though the taxpayers never benefited from any deduction for depreciation. The loss is reduced by insurance proceeds and other compensation received and losses not incurred in a trade or business or for income producing property are subject to a $100 floor and are deductible only to the extent the loss exceeds 10% of adjusted gross income. Failure to file an insurance claim with their insurance company precludes disaster victims

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40 Reg. Sec 1.165-7-(b)(ii)
41 Reg. Sec. 1.165-7-(b)(3),Ex.(2)
42 Reg. § 1.167-7(b)(2)(ii)
43 Publication 334, **Tax Guide for Small Businesses**
44 39-1 USTC ¶ 9229

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from taking their disaster losses[45]. There is no similar requirement for losses incurred in a trade or business.

DOCUMENTING PERSONAL PROPERTY LOSSES

The major problem facing disaster victims is evidence. Uninsured victims must prove to the IRS that they owned the items they lost in the disaster, and that it had the value they claimed on their tax return. Insured disaster victims must prove to the insurance companies that they owned what they lost, what it cost to replace it, and then must go out and purchase it to get compensated fully by the insurance company. While ownership of real property is a matter of public record, and whereas most businesses have extensive records of items purchased for use in the business, most homeowners who lose their personal property in a disaster have very little or no evidence of what they lost. While some may have videotapes of the contents of their home, almost no one keeps meticulous records of their yearly personal property purchases and keeps those records in a safety deposit box.

The IRS wants evidence of the property's cost or other adjusted basis in the form of receipts, cancelled checks, or credit card statements. When disaster victims lose everything in a fire, flood, or tornado, they generally may be able to produce the current year's bank statements, credit card transaction and even photocopies of their checks for years, but they generally do not have the actual receipts proving the nature of the purchase.

Evidence accepted by the courts

The courts have taken a more lenient approach to the reconstruction of evidence where disaster victims have lost all their books and records. In ***Wroblewski***[46] the court accepted a disaster victim's estimate of the fair market value (one-half of the original cost) of the destroyed items submitted in a detailed four-page schedule, which he attached to his tax return. The IRS's estimate, made by a Salvation Army outlet store, which was one-third of the disaster victim's value, was rejected because the court held that the taxpayer was familiar with the items lost and was better able to appraise them than the Salvation Army employees. The Tax Court has also allowed the value of the losses from a fire substantiated by an itemized list prepared by the disaster victim and an experience interior decorator that was familiar with the contents of the home. In discussing the inventory schedule, the court stated that in so far as it identified the items in the house and

[45] 165(h)(4)E)
[46] TC Memo 1973-37, Cornelius, 56 TC 976,1971; Stone V Comm, TC Memo 1972-211

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supplied the cost thereof, it is probably as accurate and complete a list as could be prepared. Because the list didn't factor for the age of the contents, the court reduced the value of her contents by 23% [47]. In spite of decisions like these, the IRS continues to request photos of the items lost, cancelled checks and invoices of recent purchases, and they continue to use thrift store valuation to measure the loss.

Compiling the Data

After a disaster, one of the greatest difficulties that victims face after dealing with the direct aftermath of the loss is determining the exact extent of the loss. Publication 584, *Non-Business Disaster, Casualty and Theft Loss Workbook*, provides worksheets to begin the process. But that is just the tip of the iceberg. The task can be very daunting especially if the victim's records are destroyed. The first step is to take pictures of the devastation. Friends and relatives can be asked for copies of pictures they had taken in the destroyed home. A workbook listing hundreds of items normally found in a home can be reviewed[48]. Catalogs from various department stores and mail order firms can be checked for prices that can be used as guides for the value of the destroyed property.

Victims should make a detailed list, which includes the age of the property, to help ascertain the exact value for the items destroyed. They can use statements from credit card companies and the checkbook to ascertain the cost of recently acquired property. Copies of cancelled checks obtained from the victim's bank may help jog the victim's memory of recent acquisitions. A memo pad should be at hand at all times so when an item is remembered, it is recorded. Appraisals will be needed to prove the value of items of substantial value, such as antique furniture.

Reconstructing the cost of real property can be a problem if the victim built the house and there is no longer any record of the original costs. In such a case, local contractors can be asked for an estimate of the historical building costs and a copy of the history of the parcel and its assessed value can be obtained from the assessor's office. Since the loss is the lesser of original cost or decline in FMV, an appraisal of the fair market value of the home before and after the destruction is also needed. Where a home is partially destroyed, the cost of the repairs can often be used as a way of determining the amount of the damage as long as the property is restored to the

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47 *Shackleford*, TC Memo 1948-190

48 Carol Philips," Household Inventory Guide",(I.P.P. Press, Emeryville, Ca)

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condition that it was before the disaster[49].

Because of the number of disasters that occur each year we need to tell our clients that they should make videotapes of the exterior and interior of their homes that should be placed in a safety deposit box, or at the very least, stored somewhere else other than the residence. Since we often keep permanent records of our client's basis in their residences for tax purposes, one of the questions that could be included in the annual tax organizer should be a question about improvements made during the year. We should also tell our clients to keep receipts for purchases of items over a $1,000.

Calculating loss of property held for other than use in a trade or business or for investment

When a personal residence is destroyed, no allocation is to be made between land, building and landscaping.[50] If more than one item of non-business property is destroyed in a disaster, ***Rev. Rul.*** **66-50** requires the personal property to be listed item-by-item with the loss for each item computed. The separate losses are then combined to determine the allowable loss. However, the IRS's approach in Publication 584, is to aggregate the lower of the original cost or the decline in fair market value of the numerous household items listed, compare this to the total insurance proceeds or other specific grants received to arrive at the amount of the allowable loss before limitations.

This is contrary to the instructions for **Form 4684, *Casualties and Thefts*.** **Form 4684** requires an item-by-item computation of gain or loss realized. If the approach of Publication 584 is used, the lower of original cost or "depreciated value" is aggregated, and netted against the total insurance proceeds received. Under Form 4684's approach, the insurance proceeds are allocated to each of the numerous items lost, and the gain or loss is computed individually. It is possible using the Form 4684 approach, that even if the amount of insurance proceeds paid out is less than the sum of the original cost of the items destroyed, a gain could still be recognized. It is not the intention of the law to have taxpayers recognizes gain in this situation. Unless disaster victims receive reimbursement on an item by item basis, their loss should be computed following the instructions of Publication 541.

Casualty losses may give rise to an NOL

If the casualty loss deduction is more than the victim's income

[49] Reg. Sec. 1.165-7(a)(2)(ii), Lutz v Comm, TC Memo 1976-146
[50] Reg. 1.165-7(b)(2)(ii) and 1.165-7(b)(3), Example (3), Whipple V US (D.Mass, 1928), 1 USTC ¶ 304; Buttram v Jones (W.D. Okla, 1943) 43-1 USTC ¶ 9359

for the year, the excess deduction may qualify as a net operating loss. The NOL may be carried back two years[51] and forward twenty years or the carryback can be foregone and the taxpayer can elect to carryforward the disaster loss[52].

The election to carryforward the loss must be made on a timely filed tax return[53]. Carrybacks are claimed by filing a separate 1040X for each of the carryback years[54]. Under California law, the disaster loss is accorded special treatment, and is not considered part of an NOL[55]. The loss is carried forward at 100% to the earliest of 5 taxable years following the loss and if there is remaining loss, it is reduced to 50% and carried forward to the next 10 years[56].

Property tax relief available when a disaster strikes
When a disaster strikes local property tax relief is available. County assessors are mandated to view the subject property and reduce the property tax valuation to reflect the decrease in its fair market value [57]. Their local assessors alert taxpayers who lose their home in a large disaster generally to this. However, taxpayers who lose their home in a single event generally don't think to call their assessor and request a reduction in valuation. This reduction in value remains in place until the property has been restored or repaired.

Taxpayers who rebuild at the same site have a reasonable period of time in which to rebuild, while those who rebuild or purchase within the same county have three years from the date of the disaster in which to claim this benefit [58].

Taxpayers who move outside of the county will be able to transfer their tax base only if that county adopts the provisions of Proposition 171[59], and only if the value of the replacement property is equal to or less than the fair market value of the destroyed property just prior to the disaster.

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[51] For year beginning before 8/5/97 the carryback period was 3 years and the carryforward was 15; there is still a 3 year carryback for certain NOL's. IRC 172 (b)(F)(ii).

[52] See IRS §172(b)(1)(F)(ii)(II) for special treatment for qualifying small business.

[53] 172 (b)(3)

[54] Neely, 539 T.M., Net operating losses- Concepts and Computations

[55] California Revenue & Taxation Code § 17207(e) & 24347.5(b)

[56] California NOLs are currently under suspension; please check the current status and
carryforward years.

[57] California R&T 7C § 69.

[58] SB 1824 amending R&TC § 69

[59] Proposition 171, enacted November 6,1993, amending R&TC § 69.5.
105% of FMV if purchased within one year, 110% if purchased within 2 years and 115% if purchased within 3 years

The provisions of Proposition 171 are not as lenient as those under California Revenue and Taxation Code 69 which allows disaster victims to transfer their tax base to a new home purchased within the country that is greater than the fair market value of the home destroyed. If the home costs less than or equal to 120% of the FMV of the old home just prior to the disaster, there is no increase in the tax base. If the purchase price is greater than this, that "excess purchase price" is subject to current market valuation. Under the rules adopted by Proposition 171, inter county transfers are available only to those homeowners who purchase a replacement residence that is less than or equal to the fair market value of the home immediately before its destruction. If the replacement residence is more than an indexed amount,[60]the taxpayer is precluded from this benefit.

Trusts, estates, partnerships and S corporations- Which taxpayer takes the loss

It is clear that in the case of trusts and estates that losses suffered are part of the corpus and under the Uniform Principal and Income Act of California such losses are not passed through to the beneficiaries. The 10% limitation on personal casualty losses applies to estates and trust, although administration expenses are allowed as a deduction in arriving at AGI. Under Section 165(h)(4)(D) a personal casualty loss suffered by the decedent can be taken either on the decedent's final return or on the estates final return. The Tax Court in ***Smietanka*** [61] disallowed a casualty loss taken by a taxpayer incurred by the trust. The taxpayer possessed a potential remainder interest in the trust and did not own an interest in it.

S Corporations and Partnerships:
It is not clear whether casualty losses incurred by an S corporation need to be separately stated in order to be reflected as an itemized deduction at the shareholder level. Under the general rules of § 1366, only those losses that would be subject to a limitation at the shareholder level would be separately stated. Since losses incurred by an "S" Corporation would almost always be incurred in a trade or business, it would not appear that these would not be required to be separately stated. It would appear that losses would have to be separately stated when they are not related to a trade or business or a profit motive.

Consistent with the entity concept of partnership taxation, § 703(b) provides that "any election affecting computation of

[60] IBID
[61] 41 TCM 451

taxable income from a partnership should be made by the partnership except for 3 specified elections not applicable to casualty losses. Generally the partnership would make the election under Section 165(i) to treat the loss as occurring in a prior year. However, if a loss were of a personal nature, it would appear that it would be required to be separately stated.

Electing to take the loss in the year preceding the disaster
Disaster victims may take the disaster loss in the year of the disaster or in the year preceding the loss under Section 165(i). This election must be made on or before the *later* of (1) the due date for filing the income tax return (determined without regard to any extension of time) for the taxable year in which the disaster actually occurred, *or* (2) the due date for filing the income tax return (determined with regard to any extension) for the taxable year immediately preceding the taxable year in which the disaster actually occurred.

California has enacted a more liberal law that allows disaster victims to make this decision as late as the filing date including extensions of the tax year in which the disaster occurred[62]. While the federal law does not conform, it is possible to request an extension of time to elect to take the loss in a prior year. In **PLR. 9145009**, the IRS granted an extension of time to take the loss in the year preceding the disaster when the accountant failed to notify the disaster victims of the election requirements and the disaster (freezing of crops) occurred at the end of the year, resulting in insufficient time to determine the amount of the damage by the due date of the return. For these reasons, the Service granted an extension of time to elect to take the disaster loss in a preceding year[63].

If you elect to take the disaster loss in the preceding year, you must file form 1040X, *Amended US Income Tax Return*. The IRS in Publication 547 allege that you have 90 days after filing this return in which to rescind your election. While Reg. § 1.165-11(e) state that the taxpayer has 90 days in which to revoke the election, the Tax Court in ***Matheson*** ruled the regulation invalid[64]. They held that the intent of the legislation was to give taxpayers immediate help, but a comparison of the relative tax benefits might not be possible until the time for filing their returns for the year of the loss. If a Section 165(i) election is made, it applies to the

[62] SB 1234 enacting R&TC § 17207(g).See FTB Publication 1034 and 1034A-4. Each disaster requires enabling legislation to add it to R&TC 17207(g). It is usually granted.

[63] See also Rev Proc 79-63
[64] 74 TC 836

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entire loss sustained by the taxpayer[65].

Estimated Tax Payments and disaster losses
Disaster victims who suffer a disaster loss often stop making estimated tax payments because they believe that the casualty loss will wipe out all their tax liability. This is a pitfall for many self-employed disaster victims. While the casualty loss does reduce their income tax liability, it does not reduce their self-employment tax, unless they lose business property that has not been fully depreciated or expensed or inventory. My experience in the disaster here in Oakland is that taxpayers believe that their losses are valued at the replacement cost of their items lost and calculate their loss based upon this misconception. In reality there loss is much smaller. Generally uninsured disaster victims don't get much tax benefit from the tax law. Their economic loss far outweighs their tax loss.

CASUALTY LOSSES AND PASSIVE ACTIVITY LOSSES:
As a result of the Loma Prieta earthquake of October 17,1989 the IRS issued a temporary ruling which was finalized in the regulations under Section 469 that provide that losses sustained in a disaster are not limited by Section 469 but are governed by the rules under Section 165(c)(3)[66].

II.INVOLUNTARY CONVERSIONS

Period of time in which to replace property
Under Section 1033(a), no gain is recognized if money received for property that is compulsory or involuntarily converted is spent to purchase property or stock in a corporation owning property that similar or related in service or use to the converted property within specified time periods. Generally taxpayers have two years from the end of the first taxable year in which gain is realized to reinvest the proceeds in property that is similar or related in service or use. Gain is realized when the amount of the insurance proceeds or condemnation award received exceed the adjusted basis in the asset. Amounts paid directly to the holder of a mortgage are considered amounts paid to the taxpayer[67].

[65] Reg. § 1.165-11(d)4 TC 836

[66] see also T.D. 8477, 58 Fed Regl 11537 (2/26//93), IRS has finalized proposed and temporary regulations issued in 1990. The final regulations provide that passive activity gross income does not include any gross income attributable to the reimbursement of a casualty loss if it is includible as reimbursement under Regl §1.165-1(d)(2)(ii) and the deduction for loss was not a passive activity deduction, Regl § 1.469-2(c)(7)(vi)

[67] Wala Garage, Inc v U.S., 163 F.Supp 379, 1958

While it is clear that the basis for real property held for productive use in a trade or business or for investment is allocated between land and building, Section 1033 is silent as to whether homeowners who lose their homes must allocate their basis between land and building. The Tax Court in ***David Alexander*** [68] did not allocate basis. If allocation were required, some disaster victims may realize gain in an earlier year. In 1996 the IRS in response to our concerns issued **Revenue Ruling 96-32** holding that no allocation of basis was required[69].

EXAMPLE:

Lupe Miller purchased his home in 1976 for $80,000 and made improvements to it of $100,000 before Hurricane Iniki destroyed it in September 1992. In November 1992 his insurance company paid him $153,000 for his home. If he is required to allocate basis between land ($30,000) and building ($150,000), he has realized gain in October 1992 and has 4 years, until December 31, 1996 in which to replace it. If he is not required to allocate his basis, he has no gain, and possibly a disaster loss.

Period of time to replace other types of property

There is a three-year rule for certain involuntary conversions of real property held for productive use in a trade or business under Section 1033(g)(4) and a four-year rule for personal residences damaged in a presidentially declared disaster on or after Sept. 1, 1991 under Section 1033(h)(1). If taxpayers are unable to complete reinvestment within these time periods, Section 1033(a)(2)(B)(ii) provides that an extension of time can be granted. Requests supported by reasonable cause for failure to complete reinvestment are made to the local District Director on or within a reasonable period of time after the expiration of the replacement period. Reliance on the advice of a reputable attorney and accountant that no gain was to be recognized was reasonable cause for failure to file a timely application to extend the replacement period[70] because the advisors were held to be knowledgeable. Where reliance was placed upon a tax advisor who had slight experience the benefits of ***Rev Rul 72-27*** were denied to the taxpayer[71]. In ***PLR***

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68 TC Memo 1984-653

69 In this ruling the service also held that the vacant land sold subsequent to the disaster would be considered part of the involuntary conversion and the proceeds treated under 1033 and deferrable.

70 Rev Rul 72-27

71 Casalina Corp, 60 TC 694; see also Marinello Associates, Inc (Ca-1), 76-1 USTC ¶ 9415

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9237012 a taxpayer was granted an extension of time where delay was due to litigation. Extensions can be granted whether the property is "2"," 3", or "4" year property[72].

Elections to defer gain realized under Section 1033

The election to defer gain is made by including in the tax return of the years in which gain is realized the details of the involuntary conversion[73]. Failure to include gain in gross income in any year gain is realized shall be deemed to be an election by the taxpayer to have the gain recognized only to the extent provided under Regl §1.1033(a)(2)(c)(2). The statute of limitations for the year in which gain is realized does not begin until the taxpayer notifies the District Director that the money has been reinvested in replacement property[74]. Notification is accomplished by including the details of the involuntary conversion and the amounts received and reinvested along with a description of the property in the tax return for the year in which the replacement occurs. Earlier notification is accomplished by sending a letter to the District Director[75].

CHANGING A PREVIOUS ELECTION

Revocation of a previous election (made by omitting the gain realized from income in the year realized) appears to be possible only in 3 specific situation under Reg §1.1033-(a)-2(c)(2):

1). Where replacement is at a cost lower than anticipated at the time of the election
2). Where replacement does not occur within the replacement period
3). Where a decision is made not to replace

Once the nonrecognition election is made, it is the purchase of any qualifying property that makes the 1033 election irrevocable. While it would appear that replacement doesn't occur until property is identified to the IRS, neither the courts[76] nor the IRS attach any significance to this. However, in ***PLR 8422005*** the IRS held that neither the Code nor

72 1033(a)(2)(b)(ii), Regl §1.1033(a)-2(c)(3)

73 Regl §1.1033-(a)-2(c)(2)

74 Regl §1.1033(a)-(2)(c)(2)

75 Regl.§1.1033(a)-2(c)(5)

76 McShain 65 TC 686 (1976), Rev Rul 83-39, TAM 7809006

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regulations require that the first purchased replacement property need be designated as the replacement property. Any property replaced within the replacement period can be designated as the replacement property.

If taxpayers are not sure that deferral is the most advantageous, they should consider recognizing the gain and then electing deferral with an amended return. Regl §1.1033-(a)-2(c)(2) allows taxpayers to elect to defer the gain after filing a return reporting the gain, as long as the amended return is filed prior to the expiration of the period of time in which to make the replacement.

The IRS will not extend the period of time for electing nonrecognition treatment. In ***TAM 9138002*** they held that the statute is clear that extensions can only be granted of the time in which to make the replacement, and not of the time in which to make the election[77].

PROPERTY THAT IS SIMILAR OR RELATED IN SERVICE OR USE
Property that is involuntarily converted generally is either (1) non-business personal and real property (2) personal property used in a trade or business or (3) real property held for productive use in a trade or business or for investment. When Section 1033 was originally enacted, little guidance existed from Congress about the "similar or related in service or use" requirement. As is true with other code sections, the definition has been hammered out in court cases and revenue rulings. The IRS and some of the courts have taken the position that the replacement property had to have a close functional similarity to the converted property for the owner-user of realty. In ***Revenue Ruling 56-347*** replacement of a parking lot and filing station with a retail store building did not meet this test[78]. The courts were split on whether this same functional test had to be met at the owner-investor level or at the end-use level for owner-investors. In ***Pohn***[79] the court ruled that the test was to be applied at the owner-investor level and allowed nonrecognition where a filing station was replaced with an apartment building.

In **Clifton Investment Company**[80] the court rejected this

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[77] See Santucci v Comr, 32 T.C.M 840(1973).Taxpayer realized gain from an involuntary conversion which he recognized on his tax return. Later he was audited after the replacement period had expired. He argued that he should be granted an extension of time in which to make the election and replace. The courts were clear that the election had to be made timely. The statute provided only for an extension of time in which to replace the property.
[78] See also Collins V Comm, 29 TC 670 and Rev Rul 77-192,1977 -1 CB 249
[79] B. Pohn, 62-2 USTC ¶ 9774
[80] 63-1 USTC ¶ 9246

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functional test or end use test, which takes into account only the actual physical end use to which the property is put whether that use be by the owner-taxpayer or by his tenant as it applied to owners of investment property. In so holding the court ruled that Congressional intent was that the taxpayer have a continuity of interest as to the original property and its replacement in order to not be given a tax-free alteration of his interest. The court in ***Clifton*** developed a standard that still applies today under Section 1033(a) when an owner-investor has his property destroyed in a disaster. The standard promulgated and followed by the IRS is that the properties must be reasonably similar in the relation to the taxpayer which reasonableness is dependent on a number of factors, all of which turn on whether or not the relation of the taxpayer to the property has been changed. The ultimate use does not control when the taxpayer is not the user of the property. In **Liant Records**[81]the court compared the extent and type of management activity, amount and kind of services rendered by the taxpayer to the tenants and the nature of his business risks connected with the property. As is usual, each case is dependent upon its set of facts and circumstances. Applying this standard the court rejected the nonrecognition of gain in ***Clifton*** because it considered there to be a material variation between the relation of the office building condemned and the operation of a hotel. While both properties were held for rental income, the services and management and relation to the tenants were significantly different in the operation of a hotel.

The controversy over whether the holder of investment property had to met the close functional test waged on and in ***McCaffrey***[82]gain on the involuntary conversion of a public parking lot could not escape recognition where proceeds were invested in the stock of a corporation owning a rental warehouse because the Third Circuit applied the test to the end use of the owner-investor. This controversy was resolved with the enactment in 1958 of Section 1033(g).

For all involuntary conversions, **OTHER THAN DESTRUCTION**, property held for productive use in a trade or business or investment can be replaced with property that is like kind under the more liberal rules of Section 1031(g)[83]. In **Revenue**

[81] 62-1USTC ¶ 9494

[82] 60-1 USTC ¶ 9271

[83] Section 1033(g) hold that for purposes of subsection (a) , if real property (not including stock in trade or other property held primarily for sale) held for productive use in trade or business or for investment is (as the result of its seizure, requisition, or condemnation, or threat or imminence thereof) compulsorily or involuntarily converted, property of a like kind to be held

Ruling 72-424 proceeds received for the condemnation of a taxpayer's business that consisted of a park and boating facilities qualified for nonrecognition when reinvested in an apartment building.

Unfortunately taxpayers whose property is involuntarily converted by the destruction of their realty must comply with the close functional test of 1033(a). Yet even under this section there is a distinction between owner-users and owner-investors. The IRS in light of the appellate court's decision in ***Liant Record,Inc v. Commissioner*** [84]looks at the similarity in the relationship of the services or uses which the original and replacement properties have to the investor owner[85].

An owner-investor leased out a light manufacturing plant which was destroyed by fire. He replaced it with a wholesale grocery warehouse and was accorded non-recognition treatment. Yet an owner-user of a light manufacturing plant who replaces his business with a wholesale grocery warehouse would be taxed [86].

Personal residences destroyed in presidentially declared disasters

On Aug. 10, 1993, President Clinton signed into law, the provisions of the Revenue Reconciliation Act of 1993. Included in that act is Section 1033(h)1)[87] that applies special rules to principal residences damaged in presidentially declared disasters occurring on or after Sept. 1, 1991. In such cases no gain is recognized by reason of the receipt of insurance proceeds for unscheduled personal property that was part of the contents of such residence. In the case of any other insurance proceeds, the proceeds may be treated as a common pool of funds. If such pool of funds is used to purchase any property similar or related in service or use to the converted residence (or its contents), the taxpayer may elect to recognize gain only to the extent that the amount of the pool of funds exceeds the cost of the replacement property.

Principal residence is defined as under IRS § 121, and renters are accorded the same benefit if they receive insurance

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either for productive use in trade or business or for investment shall be treated as property similar or related in service or use to the property so converted. See also Reg. 1.1033(g)-1 & 1.1031(a)-1

[84] 303 F(2d)326 (1962)

[85] Rev Rul 64-237,1964-2 CB 319, PLR 9326042, Rev Rul 71-41,1971-1 CB 223

[86] IBID Rev Rul 64-237, see also RR 76-390 where an owner-operated motel replacing an owner-operator mobile park home was not accorded nonrecognition treatment.

[87] Revenue Reconciliation Act of 1993, P.L.103-66, Section 13431()b); AB 1228 conforming California Revenue and Taxation Code § 18037(a) to federal law

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proceeds as a result of the involuntary conversion of their residence. They qualify for relief under 1033(h)(1) if the rented residence would be considered their principal residence if they owned it.

The new law codifies the fungibility concept adopted by the Tax Court in ***Massillon-Cleveland-Akron Sign Co***[88], and treats the home and its contents as one functional unit. Ben Sanchez[89] of the Regional Counsel's Office of the San Francisco district believes that the law does not allow disaster victims to treat their real property and scheduled personal property proceeds as one common fund, which can be used to rebuild and refurnish the home.

EXAMPLE:
Mary Henry has lived in her home for the last 20 years and was age 72 at the time that her home was destroyed in a presidentially declared disaster, October 20,1991. She settled with her insurance company for $320,000 for her home, and $90,000 for contents. She buys another home for $300,000, and spends the $70,000 on furnishing the home. While Mary has spent her "common fund" of $320,000 on home and contents, under the IRS's approach Mary recognizes gain because she spent part of "realty" money on contents ($20,000). Under the alternate interpretation, she would recognize no gain for she had reinvested her "common fund" in a home and contents.

Legislative History
When Ron Dellums, Pete Starke, and Diane Feinstein[90] introduced the provisions of Section 1033(h)(1), they stated that the provision was intended to provide relief to disaster victims, and allow them to reinvest their insurance funds in a way that they needed in order to rebuild their lives after the disaster. The goal of the bill was 1). To prevent taxation on phantom gain that could occur because homeowners don't keep extensive records of the cost of their contents 2). To free disaster victims from the burden of the close functional similarity test hammered out by the courts, and to remove the onerous restrictions as promulgated in ***PLR 8127089***.

In that ruling a taxpayer who lost scheduled artwork was required to recognize gain because he replaced lithographs with watercolors! The Service ruled that artwork in one medium was not functionally similar to artwork in another medium. Under

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88 15 TC 79 A. 1950-2CB3

89 see Appendix A not included for this conference

90 see Appendix B not included for this conference

the spin given the new law by the IRS, disaster victims who spend their common pool of funds on unscheduled contents would be taxed.

Again, because of our concerns and the efforts of the community of Oakland, and the local district technical coordinator, Joseph Calderaro, the Service in 1995 issued **Revenue Ruling 95-22** which provides guidance in this area and makes it clearer **that amounts received for scheduled personal property are part of a common pool of funds which can be spent on replacing home and or content**.

In **ITA 200114046** the IRS issued more favorable guidance holding that 1033(h)(1) applies to exclude gain resulting from insurance proceeds received for unscheduled personal property that was destroyed in a Presidentially declared disaster even though the property was not physically located in the taxpayer's principal residence at the time it was destroyed.

Similar or related in service or use for homeowners who lose their homes in a disaster other than a presidentially declared disaster

Unfortunately, homeowners who lose their homes in *other* than a presidentially declared disaster will have to battle the Service if they take the position that their funds are fungible, and spend their recoveries in a manner different than the allocation agreed to with the insurance company.

What constitutes property that is similar or related in service or use to a personal residence and its contents? **Revenue Ruling 76-84** holds that residential rental property replaced with a personal residence is not similar property [91]but there is nothing that addresses whether a single-family residence can be replaced with a condominium. The logic of the functional test would suggest that is makes no difference if a five-bedroom, one-bath residence is replaced with a three-bedroom, two-bath condo.

Can one residence be replaced with two?

In **Rev Rul 58-396** the Service said yes because both were personal residences, one occupied by the parents, and the other by their son. In a January, 1993 IRS public meeting with local tax practitioners, the local IRS technical coordinator confirmed that Washington agreed that this ruling applied, but no other public ruling has been forthcoming. Other than **PLR 8127089** that deals with scheduled personal property, there is nothing published about general household contents.

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[91] See also Erickson v Comm, 598 F2d 525

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While Section 1033(h)(1) addresses this for taxpayers who lose their homes in a presidentially declared disaster by exempting the proceeds received for unscheduled personal property, taxpayers who lose their home in another way still have to grapple with what is similar or related in service or use when they lose their home and everything in it. The experience here in the Oakland fire indicates that the Service may not be willing to take the more global approach to the problem.

Originally, when the San Francisco IRS district office was approached for guidance about what constituted replacement property for contents, the first guidance from the National Office of the IRS stated that the taxpayer must look to each item lost, and replace it with its functional equivalent. Taxpayers who lost a phonograph player could replace it with a compact disk player, but not with a stereo TV.

The Service has since relented in its position, and in a letter dated March 17, 1993 to Rep. Ron Dellums (D-CA), Stuart Brown[92], Office of Chief Counsel, IRS reiterates the more liberal position later taken by the San Francisco district in its information letter of March 19, 1992[93].

In that letter, the San Francisco district stated that if specifically identified antiques or collectibles of substantial value were destroyed, the replacement property would have to be similar to the item destroyed (***e.g.***, a destroyed painting could be replaced with another painting but not with jewelry or coins). "A taxpayer who receives insurance proceeds as compensation for the loss of general home furnishings and contents (as distinguished from valuable antiques, collectibles or similar items) may avoid current recognition of gain under Section 1033 provided the proceeds are used to acquire new contents and furnishings that are generally similar to what was destroyed. In determining whether new contents and furnishings are generally similar to what was destroyed, the Service will not ordinarily require a specific matching of new and old items (except specifically identified items of substantial value)."

While it may be argued that items that were covered under a specific insurance rider (scheduled personal property) have to meet the functional test hammered out by the courts, there is absolutely no authority for their distinguishing between ordinary household contents, collectibles, and items of substantial value that were covered under the unscheduled

92 see Appendix C not included

93 see Appendix D not included

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personal property provisions of the insurance contract.

Until the Service issues a revenue ruling promulgating their view, advisors will grapple with the contents dilemma. Advisors may decide to rely upon the court's holding in ***Massillion*** that proceeds received for real and personal property is one common fund. It is possible that akin to the Service's rulings under 1033(a)[94] they will take a more liberal view of contents money.

Example:

Jane Mono lost her home as a result of a fire that started during a remodeling project. She receives the policy limits of $75,000 for contents, and $150,000 for her home. The cost to rebuild is $225,000. Her cost basis in the inventory that she can remember is $30,000, and its replacement cost is $100,000. If she uses her contents money to pay for the code upgrades required to rebuild her home, she could be taxed on $45,000 of gain. Until Section 1033(h) is amended to apply to all homeowners whose homes are destroyed, the concept of fungibility seems a workable solution to the problems facing these taxpayers.

Personal property used in a trade or business
In the aftermath of the Okalahoma bombing in 1994, Congress enacted IRS 1033(h)(2) which treats tangible property as similar or related in service or use to any other tangible property, thus extending the concept of a common pool of funds to business owners[95]. Of course under the results of ***Massillion business*** owners already had support for this treatment [96]

Treatment of insurance recoveries for additional living expenses
Part of a typical homeowner's policy includes payments for additional living expenses incurred when the home is damaged or destroyed. Such payments are commonly referred to as "loss of use" or "additional living expenses". Prior to the enactment of Section 123, such payments were exempt from tax.

Current law requires disaster victims to not only remember what their living expenses were prior to the disaster, but also keep

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[94] see citations at footnote 80 & 81

[95] The reason for this rule is that property damage in a Presidentially declared disaster may be so great that the businesses are forced to suspend operations for a substantial time. During that hiatus, valuable markets and customers may be lost. These rules offer relief to those businesses by allowing them to reinvest their funds in any tangible business property without being forced to recognize the gain.

[96] IBID

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meticulous record after the casualty to determine whether any of the settlement is taxable. The amount that is excludable is that amount which is paid to the insured for living costs ***over and above*** "normal" costs.

Normal living costs are rent, utilities, food, laundry, transportation costs and other miscellaneous services. It does not include mortgage expense. Excess costs are items such as the costs of temporary housing, utilities, food, including meals at restaurants and other living expenses directly related to the disaster.

Here is a typical breakdown of the expenses of a homeowner after a fire:

	Monthly Living Expenses--Homeowner		
	After fire	*Before fire*	*Change*
Rent	$2000	$ 0	$2000
Utilities	150	100	50
Meals	1000	500	500
Transportation	80	160	(80)
Laundry	100	10	90
	$3330	$770	$2560

If the homeowner is reimbursed $3,000 a month for excess living cost, the excess reimbursement of $440 per month is includable in income. In the Oakland firestorm, many insureds made settlements with their insurance companies and received a lump sum for the anticipated time that it would take for them to return to their homes. Because of our concerns, the IRS clarified when the excess would be includable in income. Under ***Rev. Rul.*** **93-43**, the excess portion of the insurance proceeds received is includable in gross income for the taxable year in which the loss period ends, or, if later, for the taxable year in which the excess portion of the insurance proceeds is received.

Because of the number of homes destroyed, and the shortage of adequate rental units in a disaster area, a number of disaster victims buy themselves a temporary interim residence or else moved in a unit they previously owned. These taxpayers incur no excess living costs for rent, and will be subject to tax on the settlements they received from the insurance company. Can the argument be made that the cost of selling the interim home should be considered part of the taxpayer's additional living expenses directly related to the fire? Should the code discriminate against those who rent and those who purchase an interim home? Currently it does. Whether the code is correct in ignoring the true capital costs of such a situation, is a fight that has yet to be waged.

Since the loss of use insurance proceeds are exempt from income as long as they are spent on allowable excess living costs, it would appear that under the aegis of Section 265, disaster victims who are entitled to take an office in the home deduction under Section 280A would be precluded from doing so, if the rent is paid out of the loss of use allowance. Clarification as to when excess insurance proceeds received for additional living expenses is given in Rev Rul 93-43. Here the IRS ruled that insurance proceeds that exceed the increased living expenses are includible in gross income for the taxable year in which the loss period ends, or, if later, the taxable year of receipt.

Deductibility of mortgage interest following the disaster
What about the deductibility of the interest expense incurred on the outstanding mortgage, which is now secured, only by the vacant lot, and the charred remains of the homes that once dotted the hills. Does that vacant lot constitute a "qualified residence" for purposes of Section 163? While the drafters of the changes to Section 163 did not envision a disaster, they did indicate that they would foresee circumstances where a taxpayer would incur interest expense on a mortgage on a home that was not yet habitable[97]. The rules under Temp. Reg. 1.163-10T (p)(5) allow homeowners who build a home to reclassify interest expense incurred during a 24 month period prior to occupancy as qualified residential interest. This issue was raised with the IRS immediately after the firestorm of 1991, and while they addressed it in an information letter issued March 19,1992 and again in Stuart Brown's letter of March 17, 1993, no public ruling was forthcoming until 1996, when the service issued **Revenue Ruling 96-32.** In that ruling they held that the interest is deemed to be qualified residential

[97] CCH 1992 Federal Tax Guide Reports ¶ 21,671, 2/21/92

interest.

Land divisible from the residence?
A number of people, who purchased new homes, kept their vacant lots after the disaster because they are unable to sell them. The glut of the market, and the barrenness of the disaster area resulted in prices of lots plummeting. If the lot is sold and the proceeds are used to purchase a replacement residence, can it be argued that the economic-unit theory of Section 1033 applies? Under this test property that bears a substantial economic relationship to the property involuntarily converted is treated as part of one economic unit and even though that property was not involuntarily converted it is accorded nonrecognition treat. In ***Masser*** [98] the court accorded 1033 treatment to the sale of the realty remaining after a parking lot necessary to the ongoing business was condemned. It is clear that the involuntary destruction of the residence does not change the character of the lot and should be treated as part of the involuntary conversion.

In response to our concerns, Washington confirmed this position finally in 1996 with the issuance of **Revenue Ruling 96-32**. This ruling holds that the economic theory does apply to personal residences. Lots sold will be accorded nonrecognition treatment, as long as the amount was reinvested in the replacement property. In **PLR 9334007**, the IRS stated that where the economics of rebuilding a small home in a tornado-impacted area would result in a loss to the victim, the theory applies to property used as rental property.

Conversion into investment property
What happens if homeowners are unable to sell their lots, and hold on to them and convert them to investment property, while continuing to hold the mortgage. If would appear that the interest would become investment interest, subject to the rules of Section 163(d). At what point in time does the interest stop being qualified residential interest and become investment interest? I would argue it would depend upon the facts and circumstances. Certainly holding the lot for sale from the time around the purchase of the replacement residence argues that it was still qualified residential interest. On the other hand, never placing the lot for sale would suggest conversion to investment at an earlier point in time. The question begs no answer if the taxpayer has enough investment income to

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[98] 30 TC 741 (1958), acq; Contrast this with the Services position in Rev Rul 83-50 where nonrecognition was denied where a homeowner moved his residence to a second lot and sought to have the gain realized on the first deferred under Section 1034.

absorb the interest expense[99]

Interplay between 1033 & 121
Elderly homeowners are hardest hit when a disaster occurs. Many in our community were unable to cope with the stress of rebuilding, and chose to buy down into a smaller home. Technically, an involuntary conversion is not a sale, but is accorded sales treatment [100] and disaster victims who meet the age and habitation requirements of Section 121 can elect to take the $250,000/ $500,000 exclusion for sales occurring after 8/5/97. In December 2002, the IRS issued regulations covering unforeseen circumstances, and now disaster victims who do not meet the two out of five year rule of Section 121 can take a partial exclusion[101] With the changes to Section 121 and the interplay with Section 1033, one must seriously consider whether to take the exclusion if the ownership and use test are met. Had that provision been available to many of the people in the Oakland firestorm, many different decisions would have been made, and the community would have suffered much less trauma.

Timing may be an issue in involuntary conversion where the disaster hits in year one, but the insurance settlement and replacement may not take place until year three or later. Are these taxpayers to be precluded from electing to take their exclusion because of circumstances over which they have little control? Should these taxpayers claim the election in an earlier year via an amended return once they know the full amount of the insurance settlement? Questions such as these remain unanswered. A real life wrinkle is how to treat the situation where gain is realized over a number of years and the gain realized in any one year may be less than the exclusion. Should the doctrine of open transactions apply here[102]?

What happens if the homeowners doesn't meet the ownership and occupancy rules of 121 as of the time of the disaster? Does the time that a homeowner is out of the residence count toward meeting the requirements? While the time out does not count, Reg. 1.121-5(d)(5)(c) provides that the homeowner is able to tack her holding period prior to the casualty to the holding period of the replacement property. Mary Henry from above decides not to move away, but to rebuild. Her home burns down

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99 163(d)(4)(B)

100 Reg. 1.1033(a)-3 & Reg 1.121-5(a)

101 IRC §121 (C) (2), TR§1.121-3 (a) & (g)

102 Burnet v. Logan, Edith, (1931, S Ct) 9 AFTR 1453, 283 US 404, 75 L Ed 1143, 2 USTC ¶736; Piper, William, (1945) 5 TC 1104, acq ; Orvilletta Inc, (1942) 47 BTA 10.

October 20, 1991, and she moves back into the home March 20, 1993. In June of 1993 she decided to sell her home and go buy a condo. Does she meet the last 2 of 5-year requirement? Yes.

Is it necessary to reoccupy the residence?
And what about disaster victims who rebuild but never occupy the residence? A number of elderly couples started the rebuilding process, and then one of the spouses died. Some widows are unable emotionally to reoccupy the rebuilt residence. A harsh result may ensue, if the surviving spouse decides to sell the rebuilt residence and buy down. However, Stuart Brown [103] indicated in his letter that the Service would look at all the facts and circumstances to determine whether taxpayers such as these would be granted nonrecognition.

If the Service rules against these taxpayers, the sale of the rebuilt residence may result in a wash or a nondeductible loss, and the purchase of the smaller home will not be deemed to be made by the deceased spouse resulting in gain recognized on the decedent's half of the gain. This may be mitigated by electing to take the Section 121 exclusion on the final return.

Who can replace property involuntarily converted?
Ida and Frank Lupine lost their home in a presidentially declared disaster in 1991. Frank and Ida settled with the insurance company in 1992 and began rebuilding. Frank died in January, 1993 when the home was 50% complete. Ida completed the construction of the residence and moved in June, 1993. Can Ida step into Frank's shoes and complete the replacement for both of them? The IRS takes the position, contrary to the Third and Fourth Circuits, that nonrecognition of gain cannot be elected where the taxpayer dies and the replacement is completed by an executor or testamentary trustee [104].

Under the District Court's decision in ***Chichester***[105], nonrecognition was granted but no step up in basis is obtained for the replacement property. If the Service were to prevail in its position, gain would have to be recognized on Frank's final 1040, and half of the new residence would get a step-up in basis.

Home office and 1033(h)
Since that portion of a personal residence used as a home office is property used in a trade or business, it would appear that disaster victims would have only 2 years in which to

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[103] In a letter to Oakland firestorm victims
[104] Revenue Ruling 64-161, 1964-1 CB 298
[105] 78-1 USTC 9458

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replace this business property. However, this seems to be inconsistent with the relief provisions and was an issue that no one thought of that February in 1992 when we met with Ron Dellums to advocate for tax relief. While the statute is silent on this point, I would argue that since an intact physical unit was destroyed, the four year window has to apply to the home office as well.

It is clear that gain realized is to be allocated between trade or business use realty[106] and personal residence where awards are paid specifically for that type of property. Many of the disaster victims in the East Bay hills did not have coverage specifically for the business use of their home. What if the insurance company specifically prohibited coverage under their homeowner's policy for home office use? Would the taxpayer be required to allocate a portion of their proceeds to the home office?

If the Service were successful in arguing that the home office proceeds had to be reinvested within the 2 year window, and if gain had to be recognized, only the gain allocable to the business use property would be includible in income[107]. Advisors may want, if they find their clients in such a situation, to request an extension of time in which to complete the reinvestment.

Does Section 1033 require direct conversion into money for the section to apply to property damaged in a disaster?
Under the economic unit theory developed under cases like ***Masser***[108], the courts and IRS have accorded non recognition treatment in certain cases where partially damaged or condemned property was sold. The question arises as to whether the property must be directly converted into money. In **PLR 8928011** the Service ruled no, following their decision in **Rev Rul 80-175.** A hospital and its surrounding grounds were irreparably damaged in an earthquake.

The taxpayers received no insurance proceeds or other types of reimbursement and rather than repair it for costs exceeding its FMV just before the quake, the hospital sold the underlying land for $2,600,000. The Service ruled that the gain realized from the sale was eligible for nonrecognition under 1033. They relied upon their decision in **Rev Rul 80-175** that 1033 did not require direct conversion into money when property is converted by destruction.

[106] Rev Rul 72-424
[107] Rev Rul 79-261
[108] IBID

Section 752(a) & 1033
Conversion of partnership property requires the partnership and not the partners to elect to replace the property. Because of the application of partnership tax rules, individual partners may recognize gain upon a conversion notwithstanding a valid partnership election to defer the gain. Partnerships may want to consider making a distribution in the year they know a condemnation may occur.

In **PLR 9022037** the partnership terminated and distributed out real property and held it as tenants in common. The IRS ruled that each joint owner could make the 1033 election, but that the partnership's investment purpose could not be imputed to the former partners. Therefore the rules under Section 1033(a) and not 1033(g) applied.

There are special problems that arise when partnerships hold mortgages in an involuntary conversion. Where encumbered partnership property is converted, Section 752 comes into play and may require gain recognition by the partners even though a 1033 election has been made.

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