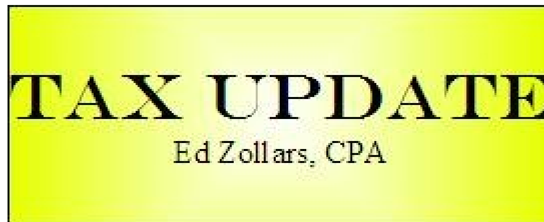

Total Devastation-Damage to a Residence and Eligibility for §121
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IRS Rules on Exclusion Under §121 in Involuntary Conversion Situation

The IRS issued Chief Counsel Advice 200734021 to deal with the application of IRC §121(d)(5) when an individual's residence is damaged. The ruling comes to the conclusion that the residence must be destroyed, not just damaged—but that the question of whether there was destruction vs. damage is one to be determined based on the facts and circumstances of the situation in question.

The Law Under §121

The general rule under §121 is fairly simple—it provides for an exclusion of gain from income if certain conditions are met. The general rule is found at §121(a), which provides:

> (a) Exclusion

> Gross income shall not include gain from the sale or exchange of property if, during the 5-year period ending on the date of the sale or exchange, such property has been owned and used by the taxpayer as the taxpayer's principal residence for periods aggregating 2 years or more.

This exclusion is limited in amount by §121(b) to $250,000 generally, with $500,000 available for married couples filing a joint return who meet certain other conditions. However, notable in §121(a) is the requirement for a sale or exchange of the property in question.

§121(d)(5)(A) provides a special definition applicable in certain cases that bring certain transactions that are not actually sales under the "sale" umbrella of §121(a):

> (d)(5) Involuntary conversions
>
> (A) In general
>
> For purposes of this section, the destruction, theft, seizure, requisition, or condemnation of property shall be treated as the sale of such property.

Thus, if there is a qualifying event that triggers a gain (such as from the insurance proceeds for the claim resulting from this damage), §121 is available to offset any gain recognized. §§121(d)(5)(B) and (C) go on to coordinate this provision with the gain deferral and basis adjustment rules for transactions that would qualify under §1033.

Of special is a difference in the language under §1033. That provision, which allows for the deferral of gain in similar circumstances if the proceeds are reinvested, starts out as follows:

> §1033(a) General rule
>
> If property (as a result of its destruction *in whole or in part*, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted--

Note that in this section the term "destruction" is modified by the phrase "in whole or in part," a phrasing not found in §121(d)(5)(A). As we'll find, the IRS considers this factor to be significant in the application of the provision.

If both provisions apply, essentially §121 applies first to reduce the gain and then any remaining gain is eligible for deferral (and the related basis adjustment) for acquisition of qualifying property. If the entire gain is offset by §121, note that there is no requirement for reacquisition of qualified property to keep from having a current tax imposed.

The Facts and the Impact of the Answer

The IRS Chief Counsel Advice noted above considers a specific fact pattern in its example of the proper application of this provision. The fact pattern from the CCA goes

as follows:

> Taxpayer's property was substantially damaged as a result of a natural disaster. The property was damaged to such an extent, that it must practicably be rebuilt. Although components of the residential structure remain standing, subsequently enacted land use regulations essentially require deconstruction followed by elevation, total first floor and roof, and near total second floor reconstruction at an expense exceeding the fair market value of the entire property prior to the disaster. The fair market value of the property prior to the damage in question is estimated at $250,000. The fair market value after the disaster is estimated at $75,000. Taxpayer's adjusted tax basis in the property is $170,000, and the costs of repair are estimated at $359,000. Taxpayer received $359,000 in insurance and other proceeds, and will receive $40,000 in excludible section 139(g) hazard mitigation payments.
>
> Taxpayer meets the ownership and use requirements of section 121(a) of the Code, and is aware that the recognition of gain may be deferred under the provisions of sections 1033(a)(2) and 1033(b). However, Taxpayer has inquired whether he may treat the involuntary conversion as itself a 'sale' under section 121(d)(5).

The taxpayer would have a realized gain of $189,000—that is, the $359,000 in proceeds received from the insurance company less his basis of $170,000. If this transaction qualifies for sale treatment via §121(d)(5)(A), then none of the gain would be taxable even if no qualifying replacement property is obtained. As well, even if the taxpayer does go ahead and obtain that property, the basis of the property would not be reduced since there would be no gain that would need to be deferred under §1033.

In the alternative, if this is not a deemed sale under §121(d)(5)(A), then if there is no reinvestment the taxpayer would have a taxable gain of $189,000. If the taxpayer does avail himself of §1033 and acquire the replacement property, his basis in that replacement property would be reduced by the gain deferred—up to the entire $189,000 if enough is expended to allow the entire gain to be deferred.

That reduced basis could come back to haunt the taxpayer even if he continues to use the property as a residence. Since the basis would be reduced, the taxpayer would more quickly run into the $250,000 limitation on a later sale. If the taxpayer is not forced to reduce basis, he would get a "fresh" $250,000 of appreciation that he could absorb. Thsu, the matter is one that could very well be of more than simply academic interest.

IRS Analysis

The IRS focuses on the issue of what exactly is meant by the terms used in §121(d)(5)(A). The CCA first considers any direct evidence of what this term means as noted below:

> Under section 121(d)(5)(A) the destruction of property is treated as the sale of the property for purposes of section 121. The statute and legislative history are silent regarding the legislative intent behind the term "destruction" as used in section 121(d)(5)(A). Further, we have found no case law defining the term for purposes of section 121. Moreover, the term "destruction" is not specifically defined for other purposes in the Code.

The IRS essentially comes up empty when looking at either the statute, legislative intent or case law directly on point on this matter.

At this point the IRS begins to analyze when the term is used in the Code and makes the following observation:

> Absent Subtitle E (Alcohol, Tobacco and certain other excise taxes), the word “destruction” is only used in the Code where a section may expressly apply to either partial or total destruction. For example, many sections of the Code use the phrase “destruction in whole or in part” (such as, sections 143 (mortgage revenue bonds), 512(a)(3)(D) (unrelated business taxable income for exempt organizations), 1033 (involuntary conversions), 1231 (long-term capital gain includes involuntary conversions of property used in a trade or business). This suggests that the term destruction may encompass both partial and complete destruction when specified.

But, as noted above, §121(d)(5)(A) does not include any “in whole or in part” type of phrasing. Based on that, the CCA comes to the following conclusion about Congressional intent:

> However, the lack of this common phrase in section 121 may indicate that Congress specifically intended the deemed sale rule of section 121(d)(5)(A) to apply only to a *complete destruction* (emphasis added).

The CCA finds support for this concept in other provisions that deal with both damage and destruction.

> Other Code sections use the phrase "destruction or damage" (such as, sections 451(d) (destruction of crops) and 1400L (tax credit for New York Liberty Zone). This suggests that the term destruction is distinguishable from damage and does not encompass partial destruction.

The CCA then goes out to search for a suitable definition of “destruction” for these purposes. The CCA analysis goes as follows:

> The meaning of the term destruction is "to ruin the structure" or "to put out of existence." Merrian-Webster Online Dictionary, http;//www.mw.com/dictionary/destruction (last visited Aug. 28, 2006). See James A. Ballentine, Ballentine's Law Dictionary, 3rd Edition 343 (1969)

> (defining destruction as "a wrecking, tearing down, breaking up, or burning up"). Cf. *C.G. Willis, Inc. v. Commissioner*, 41 T.C. 468 (1964) (stating that involuntary conversion within the meaning of section 1033(a), means that "the taxpayer's property, through some outside force or agency beyond his control, is no longer useful or available to him for his purposes"); Rev. Rul. 80-175, 1980-2 C.B. 230; *Williamette Indus., Inc. v. Commissioner*, 118 T.C. 126 (2002).

The CCA then goes on to offer two factors to be considered in determining if the residence has, in fact, been subjected to complete destruction:

> The use of the term "destruction" in the above sources suggests that, in the case of a residence, complete destruction occurs when the residence is damaged to the extent that the remaining structure cannot be utilized to advantage in restoring the property to its prior condition. Thus, one factor to consider in determining if a complete destruction of a taxpayer's principal residence has occurred is whether, based on this plain and literal meaning of the term "destruction", the residence is damaged to the extent that the remaining structure cannot be utilized to advantage in restoring the property to its prior condition.
>
> Another factor to consider in determining complete destruction of property is whether the cost of repair substantially exceeds the fair market value of the property prior to its damage. In such a case, it may not be economically feasible to repair property that has already sustained partial destruction. The lack of economic feasibility of repairing damaged property is a factor suggesting complete destruction of the property.

The first test is relatively simple—if the structure must be torn down and construction started from scratch, then the residence was destroyed. As a practical matter, I doubt anyone thought that would ever have been an issue.

However, the economic feasibility issue is obviously a more difficult (and subjective) factor. The CCA goes on to consider how this factor should be evaluated:

> Although we have found no legal authorities under section 121 that consider the economic feasibility of repair in determining the destruction of property, it is helpful to consider authorities regarding involuntary conversions under section 1033. In Revenue Ruling 80175, 1980-2 C.B. 230, taxpayers sold timber that had been damaged as a result of a hurricane. The ruling holds that gain from the sale of the damaged timber was eligible for nonrecognition under section 1033. The rationale in the ruling for including the downed timber as property that was involuntarily converted was that the sale of the downed timber was dictated by the damage caused by the hurricane: "the downed timber was not repairable, and was generally no longer useful to the taxpayer in the context of its original objective." The ruling distinguished this situation from the case in *C.G. Willis, Inc. v. Commissioner*, 41 T.C. 468 (1964), where the court considered application

> of section 1033 of the Code to the proceeds of the sale of a partially damaged ship, which, along with insurance proceeds, was reinvested by the taxpayer in property similar or related in service or use. The court in that case denied the claim for nonrecognition treatment because, since the ship was repairable, "[i]t cannot be said that the sale of the unrepaired ship was a RESULT of its partial destruction." 41 T.C. at 475.
>
> Thus, in the context of section 1033, the lack of economic feasibility of repair can result in the sale of partially damaged property being treated as part of the involuntary conversion of the property. Similarly, it would seem reasonable to consider economic feasibility of repair of a damaged principal residence in determining whether the damage amounts to a complete destruction for purposes of section 121(d)(5).

The CCA then goes on to look at the facts as presented and determines, with these facts, that the taxpayer would qualify for §121(d)(5)(A):

> Whether damage to a taxpayer's principal residence is sufficient to result in its destruction for purposes of section 121(d)(5) is a factual determination. In this particular case, there are sufficient facts and circumstances to conclude that Taxpayer's property was destroyed, in whole, as a result of the disaster. It is not required under the above rationale that the taxpayer's principal residence be completely destroyed by or at the time of the catastrophic event, only that its complete destruction be caused by such event. A residential structure that must be essentially deconstructed prior to reconstruction, has been destroyed for purposes of section 121(d)(5). From the information presented, it appears that Taxpayer's principal residence was damaged to such an extent that the remaining structure cannot be utilized to meaningful advantage in restoring the property to its prior condition. The fact that Taxpayer will nonetheless choose to reconstruct his principal residence at the same location does not vitiate this conclusion. Further, the cost of repairing the Taxpayer's residence in this case substantially exceeds the fair market value of the residence prior to the catastrophic event, thus making repair economically unfeasible. The law does not require taxpayers to make uneconomic choices.

Of course, it's important to note that the CCA dealt with a rather extreme set of facts—local law required the taxpayer to deconstruct the remaining structure in order to restore a residence to the location and the cost to repair was substantially greater than the fair value of the property in question. Thus, in these facts, the taxpayer easily met both tests.

In a less obvious situation, where the taxpayer has to rely only on the second test of the repair being economically unfeasible (likely because the taxpayer will simply buy a less expensive property elsewhere), the situation may not be so clear. Similarly, a taxpayer that decides to tear down and built a new property may have an issue with the resulting basis of the new property if the IRS were to view the decision not as one of economic

necessity, but rather personal preference. Taxpayers and their advisers will need to consider documenting the reasons and economics behind choices made.