Involuntary Conversions and Casualty Losses

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Agenda

- Overview
- Casualty losses
- Restoration costs
- Involuntary conversions — gain deferral
- Related issues

Overview

Types of transactions

- Storm damage
- Equipment malfunctions
- Condemnations

Tax terminology

- Involuntary conversion
- Casualty loss
- Single identifiable property
- Disaster loss

Casualty losses

Casualty losses

- Definition of “casualty”
- Characteristics of casualties
  - An identifiable event of a sudden, unexpected, or unusual nature
  - NOT progressive deterioration of property through a steadily operating cause
- Requirements for loss deductions
  - Evidenced by closed and completed transactions
  - Fixed by identifiable events
  - Actually sustained during the taxable year
    - Exception for disaster losses

Deduction and basis reduction

- Casualty loss deduction
  - There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise — Section 165(a)
  - Any loss arising from fire, storm, shipwreck, or other casualty is allowable as a deduction under Section 165(a) for the taxable year in which the loss is sustained — Reg. Sec. 1.165-7(a)(1)
- Basis reduction — Section 1016(a)(1)
  - Loss limited to adjusted basis — Section 165(b)

Casualty loss deduction

- Allowable loss =
  - – The lesser of:
    - Decline in fair market value
    - Adjusted basis of property immediately before casualty or theft
  - – Minus any insurance or other reimbursements expected to be received
    - If reimbursement is > adjusted basis, treat as a gain from involuntary conversion
- Repair costs may serve as estimate of reduction in value — Reg. Sec. 1.165-7(a)(2)(ii)

Requirements for using repair costs to measure a casualty loss

- Repairs necessary to restore to condition immediately before the casualty
- Amount is not excessive
- Repairs do not cover more than the damage suffered
- Value of the property after the repairs does not exceed the value of the property immediately before the casualty event as a result of the repairs

Single, identifiable property
Reg. Sec. 1.165-7(b)(2)(i)

- Loss deduction determined with reference to the SIP
- TAM 200902011 — electric T&D utility
  - Transmission — each transmission line and each transmission substation
  - Distribution — each distribution circuit and each distribution substation
- TAM 201014052 — wireline/landline telecomm
  - Subdivisions of a wire center — central office building itself, central office equipment, outside plant

Insurance recovery reduces deduction

- Reasonable prospect of recovery — Reg. Sec. 1.165-1(d)(2)
- “Right to reimbursement” = highly factual — CCA 200725031
- Deduction for replacement costs in excess of insurance proceeds received or for which there is a reasonable prospect of receiving — PLR 200730010
- Prospect of recovery arises after year end but before return filing date — TAM 200750016

Rate recovery

- Does recovery from utility ratepayers constitute “insurance or otherwise” under Section 165?
  - Rev. Rul. 87-117 — rate recovery for abandonment loss (nuclear power plant) does not constitute “insurance or otherwise”
  - ILM 201036001 — customer reimbursement does not constitute “insurance or otherwise” even if specifically identified on customer bills
  - ILM 201145011 — casualty loss deduction not reduced by proceeds of bond issuance upon securitization of surcharge to recover disaster restoration costs

Casualty losses

Section 165(i) one-year carryback

- One-year carryback for federally declared disasters
- Carryback is an all-or-nothing proposition for each “event” — Reg. Sec. 1.165-11(d)
- Event is defined as each declaration
- Generally, federal declarations are made county by county

Restoration costs

Interaction of Sections 162, 165 and 263

IRC § 162	Costs of restoring damaged property may be deductible under Section 162 if they are repair costs to return property to its previous condition and the expenditures do not appreciably prolong the property's life or add to its value
IRC § 165	Decline in value caused by casualty event may qualify as a deductible casualty loss under Section 165; reduces basis
IRC § 263	Costs of restoring damaged property may be required to be capitalized under Section 263 if they appreciably prolong the property's life, add to its value, or adapt it to a new or different use
§ 1.263(a)-3(k)(4)	Costs of restoring damaged property may be required to be capitalized under Section 263 when the taxpayer is required to take a basis adjustment as a result of a casualty loss under Section 165 or relating to a casualty event described in Section 165

Treatment of restorations after casualties prior to the tangible property regulations

Facts	Common Taxpayer Reporting	Historical IRS View	Comment Letters
Adjusted basis before casualty	$600,000	$600,000	$600,000
Restoration costs	$750,000	$750,000	$750,000
Casualty loss deduction	$600,000	$600,000	$0
Repair deduction	$750,000	$0	$750,000
Total deductions (all restoration costs are otherwise deductible)	$1,350,000	$600,000	$750,000 (repairs)
Vintages of tax basis additions or reductions	Reduce basis of prior year vintages. No current year addition.	Reduce basis of prior year vintage. Current year addition of $750,000.	No effect on basis of prior year vintages.

Capitalization of restorations
Reg. Sec. 1.263(a)-3(k)

- An amount paid for a restoration of a unit of property must be capitalized
- An expenditure results in a restoration of a unit of property only if it ...
  - Is for the restoration of damage to a unit of property for which the taxpayer is required to take a basis adjustment as a result of a casualty loss under Section 165, or relating to a casualty event described in Section 165 subject to the limitation in paragraph (k)(4) of this section
  - ...

Capitalization of restorations

Casualty loss rule — Reg. Sec. 1.263(a)-3(k)(4)

- Amount required to be capitalized as a restoration of damage to a unit of property is limited to the excess of
  - The adjusted basis of the single identifiable property for determining the loss on the casualty, over
  - The amount paid to restore the damage to the unit of property from the casualty that would otherwise be a capitalized improvement
- Amounts in excess of the limitation are taken into account under otherwise applicable Code and regulation provisions

Basis reduction for casualty losses

- Section 1016(a) General Rule.—

  Proper adjustment in respect of the property shall in all cases be made—

  (1) for expenditures, receipts, losses, or other items, properly chargeable to capital account, but no such adjustment shall be made—

    (A) for taxes or other carrying charges described in section 266, or

    (B) for expenditures described in section 173 (relating to circulation expenditures),

  for which deductions have been taken by the taxpayer in determining taxable income for the taxable year or prior taxable years;

Casualty loss — no insurance recovery

Facts	Deductions	Depreciable basis
Adjusted basis before casualty	$600,000	$600,000
FMV before casualty	$1,000,000	
Costs to restore to pre-casualty condition	$200,000	$200,000
Otherwise capitalizable restoration costs	$0	$0
Insurance proceeds	$0	
Insurance proceeds	<$0>	<$0>
Minus: lesser of repair costs or adjusted basis	<$200,000>	
Casualty loss deduction	<$200,000>	<$200,000>
Repair deduction	$0	
Adjusted basis after casualty		$600,000

Casualty loss — full insurance recovery

Facts	Deductions	Depreciable basis
Adjusted basis before casualty	$600,000	$600,000
FMV before casualty	$1,000,000	
Costs to restore to pre-casualty condition	$200,000	$0
Otherwise capitalizable restoration costs	$0	$0
Insurance proceeds	$200,000	
Insurance proceeds	$200,000	$0
Minus: lesser of repair costs or adjusted basis	<$200,000>	
Casualty loss deduction	$0	<$0>
Repair deduction	$0	
Adjusted basis after casualty		$600,000

Casualty loss — partial insurance recovery

Facts	Deductions	Depreciable basis
Adjusted basis before casualty	$600,000	$600,000
FMV before casualty	$1,000,000	
Costs to restore to pre-casualty condition	$200,000	$200,000
Otherwise capitalizable restoration costs	$0	$0
Insurance proceeds	$150,000	
Insurance proceeds	$150,000	<$150,000>
Minus: lesser of repair costs or adjusted basis	<$200,000>	
Casualty loss deduction	<$50,000>	<$50,000>
Repair deduction	$0	
Adjusted basis after casualty		$600,000

Casualty loss — partial insurance recovery

Facts	Deductions	Depreciable basis
Adjusted basis before casualty	$600,000	$600,000
FMV before casualty	$1,000,000	
Costs to restore to pre-casualty condition	$750,000	$600,000
Otherwise capitalizable restoration costs	$0	$0
Insurance proceeds	$400,000	
Insurance proceeds	$400,000	<$400,000>
Minus: lesser of repair costs or adjusted basis	<$600,000>	
Casualty loss deduction	<$200,000>	<$200,000>
Repair deduction	<$150,000>	
Adjusted basis after casualty		$600,000

Casualty loss — partial insurance recovery

Facts	Deductions	Depreciable basis
Adjusted basis before casualty	$600,000	$600,000
FMV before casualty	$1,000,000	
Costs to restore to pre-casualty condition	$500,000	$350,000
Otherwise capitalizable restoration costs	$250,000	$250,000
Insurance proceeds	$400,000	
Insurance proceeds	$400,000	<$400,000>
Minus: lesser of repair costs or adjusted basis	<$500,000>	
Casualty loss deduction	<$100,000>	<$100,000>
Repair deduction	<$150,000>	
Adjusted basis after casualty		$700,000

Casualty loss — no insurance recovery

Facts	Deductions	Depreciable basis
Adjusted basis before casualty	$600,000	$600,000
FMV before casualty	$1,000,000	
Costs to restore to pre-casualty condition	$500,000	$350,000
Otherwise capitalizable restoration costs	$250,000	$250,000
Insurance proceeds	$0	
Insurance proceeds	$0	
Minus: lesser of repair costs or adjusted basis	<$500,000>	<$0>
Casualty loss deduction	<$500,000>	<$500,000>
Repair deduction	<$150,000>	
Adjusted basis after casualty		$700,000

Involuntary conversions — gain deferral

Involuntary conversions

- Characteristics of involuntary conversions
  - Destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof
  - Compulsorily or involuntarily
- Gain deferral rules
- Basis reduction rules
- Disclosure requirements

Involuntary conversions into property

- Gain deferral only applies to conversions into property "similar or related in service or use"
  - Generally considered to be property which is functionally similar to and has the same use as the property converted
- Non-recognition of gain is mandatory
- Basis of replacement property is basis of converted property plus any additional basis for new investment less loss recognized
- Holding period carries over

Involuntary conversions into money

- Gain deferral is elective for conversions into money or dissimilar property
- Deferral is achieved through purchase of qualified replacement property
  - Purchase of replacement property must generally occur within two years after the close of the tax year in which gain is realized
  - Failure to acquire replacement property makes gain taxable in year that gain is realized, NOT the year that failure to replace occurs

Involuntary conversion gain deferral

Facts	Deductions	Depreciable basis
Adjusted basis before casualty	$600,000	
FMV before casualty	$750,000	
Costs to restore to pre-casualty condition	$750,000	$750,000
Otherwise capitalizable restoration costs	$0	$0
Insurance proceeds	$700,000	
Insurance proceeds (fully reinvested)	$700,000	
Minus: lesser of repair costs or adjusted basis	<$600,000>	
Gain realized	$100,000	
Gain deferred	$100,000	<$100,000>
Repair deduction		
Adjusted basis after casualty		$650,000

Gain deferral elections

- Election is made by partnerships, not partners
- Once election is made the purchase of any "qualified replacement property" makes election irrevocable
- Late election is available if still within the statutory replacement period via an amended return

Gain deferral disclosure requirements

- Tax years that gains are realized
  - Notify of conversion
  - Intent to defer gain
- Tax year(s) of replacement
  - Details of replacement property acquired
  - Basis of replacement property acquired
  - Ultimate gain deferred
- Statute of limitations remains open until taxpayer notifies of replacement or non replacement

Related issues

Business interruption insurance

- Ordinary income
- Not eligible for Section 1033 gain deferral
- Treated as domestic production gross receipts under Section 199 if substituting for gross receipts that would be DPGR

MACRS depreciation

- In “simple” fact patterns – depreciate exchanged basis of replacement property over the remaining recovery period (and applicable convention) using the same depreciation method as the relinquished property
  – Special rules when recovery periods, recovery methods or placed-in-service conventions of replacement and relinquished property differ
- Depreciate excess basis of replacement property as property placed in service in the year of replacement

MACRS depreciation *(cont.)*

- No depreciation for MACRS property if it is disposed of in an involuntarily conversion in the same taxable year it is placed in service
- Depreciation is not allowable during the period between the disposition of the relinquished property and the acquisition of the replacement property

Bonus depreciation

- If the bonus depreciation requirements are met, the remaining carryover basis and the remaining excess basis may qualify for bonus depreciation
- No bonus depreciation for involuntarily converted MACRS property if the involuntarily converted MACRS property is placed in service and disposed of in an involuntary conversion in the same taxable year

ITC recapture

- Increase in tax upon early disposition of ITC property
- No exception for casualties
- Form 4255, *Recapture of Investment Credit*
- Basis increase

Questions?

Deloitte.