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Recovery From Tragedy —Casualty Losses and Capital Gain

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Recent events have sparked renewed interest in the oft-neglected provisions found in contracts and leases that relate to insurance and casualties. Similarly, on the tax side, real estate owners are now taking a closer look at Internal Revenue Code section 1033, the provision dealing with gains and losses arising from casualties.

Section 1033 generally provides that, if property is involuntarily converted into similar property (*i.e.*, "property similar or related in service or use to the property so converted") through a casualty or condemnation, the gain realized on the conversion of the property is not currently taken into account, that is, not "recognized," for tax purposes. Rather, the basis of the converted property carries over to the acquired property. Moreover, if property is involuntarily converted into cash, such as by the receipt of casualty insurance proceeds, and the taxpayer replaces the converted property by purchasing other qualified property within the period prescribed by the statute, the taxpayer can elect to defer the gain realized in the transaction. This period is defined as "the period beginning with the date of the disposition of the converted property ... or condemnation of the converted property ... and ending ... 2 years after the close of the first taxable year in which any part of the gain upon the conversion is realized ... ."

Where real property used in a trade or business or held for investment is condemned (or transferred under a threat of condemnation), in addition to the rules described above, taxpayers can obtain relief under special rules (which do not apply to casualties or to property other than real property). Under these rules, the real property must be replaced with "like-kind property" (generally a broader standard) and three years is substituted for two years in the definition of the statutory period for replacement. In this way, at least for condemnations, section 1033 is roughly analogous to section 1031 of the Code, which provides for tax-free treatment where real property is exchanged for like-kind property, although important distinctions exist between the technical requirements of these sections.

Section 1033 provides special rules for property involuntarily converted as a result of a Presidentially declared disaster. For example, in the definition of the replacement period (within which the taxpayer can reinvest the insurance proceeds) four years is substituted for two years in the case of

a primary residence. In the case of property held for productive use in a trade or business or for investment, the replacement period is left unchanged, but the property can be replaced with any "tangible property of a type held for productive use in a trade or business." This provision would allow a taxpayer to take insurance proceeds received from the destruction of real estate in a Presidentially declared disaster and reinvest them in other real estate or in equipment or in any other tangible asset held for productive use in a trade or business.

To illustrate the provisions of section 1033, assume that an individual owns a commercial rental property with a fair market value of $20 and a basis of $10, subject to debt of $15. An earthquake destroys the building and the insurance company pays the owner $20, $15 of which goes to repay the mortgage debt. The taxpayer has "realized" $10 of gain ($20 insurance proceeds over $10 basis). If the taxpayer reinvests the $5 of net proceeds in new commercial rental property with a value of $20 (taking out a mortgage of $15), then the taxpayer may elect to treat the realized gain as not recognized for tax purposes. The effect of this election is that the taxpayer does not report any income or gain with respect to the casualty, but the basis of the new building will be $10, rather than its $20 purchase price.

Although the application of these rules is relatively straightforward, extreme complications can result when a partnership is involved. Under tax accounting principles, each partner's "share" of a partnership's liabilities is added to that partner's tax basis in his partnership interest. When the partnership's liabilities are reduced, the partners' bases in their partnership interests are correspondingly reduced dollar-for-dollar. When a partner's basis in his interest reaches zero, any further reduction in his share of liabilities results in the recognition of gain. If, in the example described above, a partnership rather than an individual owned the property, even if nonrecognition treatment were elected, the temporary disappearance of the mortgage debt would cause a problem, because, in the interim, before the property and the mortgage debt are replaced, the partners' debt shares would be collectively reduced by $15. Since the partners' aggregate basis before the casualty was $10, a $15 reduction to the partnership's liabilities would result in gain to the partners of $5. A strict, literal application of these rules results in gain recognition to the partners, notwithstanding that after reinvestment the partnership's liabilities are at $15 again and the partnership itself does not recognize gain.

There is something disturbing about applying a technical rule that results in gain to the partners in a transaction which Congress clearly intended to be a tax-free event. Why should ownership of the same building by a partnership result in tax ramifications drastically different from those that result for an individual owner? Moreover, section 1033 implicitly treats the receipt of cash followed by a reinvestment in qualified property as if the original property were converted directly into qualified property. Section 1033 does not give tax effect to any interim event; thus, its approach is at odds with recognizing an intermediate step in which a partner's share of debt has decreased.

In Revenue Ruling 81-242, the Internal Revenue Service held that on similar facts involving a condemnation of property, $5 of gain is recognized by the partners, based on the following reasoning:

> In this case, the condemnation of the building and the subsequent reinvestment of the proceeds were separate transactions that did not occur simultaneously. When [the partnership] subsequently acquired replacement property that was subject to a liability, each partner's share of the liability of [the partnership] increased. Because this increase resulted from a separate transaction, it may not be netted against the decrease in liability on the prior condemnation of the original property. Therefore, the full amount of the decrease in liability was a deemed distribution of money to the partners.

Subsequently, a more helpful ruling (Rev. Rul. 94-4) was issued providing as follows:

> A deemed distribution of money under Section 752(b) resulting from a decrease in a partner's share of the liabilities of a partnership is treated as an advance or drawing of money under [the Income Tax Regulations] to the extent of the partner's distributive share of income for the partnership taxable year. An amount treated as an advance or drawing of money is taken into account at the end of the partnership taxable year. A deemed distribution of money resulting from a cancellation of debt may qualify for advance or drawing treatment under this revenue ruling ... .

To the extent that it applies, this ruling provides that a deemed distribution caused by a reduction in a partner's share of partnership liabilities occurs on the last day of the taxable year. Therefore, if the casualty and reinvestment occur in the same taxable year, the basis increase from the liabilities securing the replacement property takes place prior to the decrease caused by the repayment of the original mortgage debt. But if the new mortgage is not incurred in the same taxable year as the old mortgage is satisfied, this Revenue Ruling will not cure the liability shortfall problem.

Ten years after Revenue Ruling 81-242 was issued, regulations were issued under section 752 of the Internal Revenue Code providing as follows:

> *Netting of increases and decreases in liabilities resulting from same transaction*. If, *as a result of a single transaction*, a partner incurs both an increase in the partner's share of the partnership liabilities ... and a decrease in the partner's share of the partnership liabilities ..., only the net decrease is treated as a distribution from the partnership and only the net increase is treated as a contribution of money to the partnership. (Emphasis added)

To the extent that it applies, this rule would help the partners in our example by allowing them to net the decrease in their liability shares caused by the casualty against the increase in their liability shares caused by the reinvestment. But what constitutes a single transaction? Since the Internal

Revenue Service never revoked Revenue Ruling 81-242, that ruling still stands as an official pronouncement that a casualty or condemnation and the subsequent reinvestment are two separate transactions, not the "single transaction" required by the quoted regulations.

Would the answer be the same in the like-kind exchange context? The like-kind exchange rules allow a "deferred exchange" to qualify for nonrecognition where the disposition of the relinquished property may precede the acquisition of the replacement property by up to six months. Such an exchange can only be achieved by adhering to prescribed restrictions. The taxpayer must identify replacement property within 45 days of the transfer of the relinquished property and must not actually or constructively receive the cash proceeds of the sale of the relinquished property. These rules, which do not apply in the casualty or condemnation context, serve to bind the two parts of the transaction together. Neither half of the transaction is coherent without the other. As a result, even if a casualty or condemnation and a subsequent reinvestment are treated as two separate transactions, and thus do not qualify for relief under the section 752 regulations, a like-kind exchange should be considered a single transaction and, therefore, should qualify for "netting" under the above-quoted regulation.

These are just some of the intricacies relating to the tax treatment of casualties that must be closely scrutinized by the real estate community in the coming months. Perhaps as part of the legislative package that Congress produces to deal with the World Trade Center tragedy, the technical glitch affecting partnership owners of destroyed property should be eliminated.

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