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Taking Some Sting out of the Gain: Deferral of Gains Resulting from Casualties and Other Involuntary Conversions

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The recent devastation caused by Hurricanes Harvey, Irma, and Maria and the California wildfires highlights the importance of understanding the U.S. federal income tax consequences for taxpayers who have suffered the loss of, or damage to, property in a casualty. For many taxpayers, the destruction caused by the hurricanes may result in casualty losses that may be deductible for U.S. federal income tax purposes under section 165.[1] However, there will also be many taxpayers who realize a gain for U.S. federal income tax purposes on the casualty because the insurance or other compensation received for the damaged or destroyed property exceeds the property's adjusted tax basis. For those taxpayers who realize a gain on an involuntary conversion, like a casualty, an election is available under section 1033 that allows those taxpayers to take some of the sting out of the gain by deferring its recognition.

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1 Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations"). For an overview of casualty losses under section 165, see, James Atkinson, *Hurricanes Harvey and Irma: Casualty Loss Deductions*, What's News in Tax (Sept. 18, 2017); Jacqueline Swilling, *Taking Some Sting out of the Loss: Casualty Loss Deductions on Individual Income Tax Returns*, What's News in Tax (Oct. 3, 2017).

The following discussion presents a brief overview of the involuntary conversion rules in section 1033 and the steps required to defer recognition of gain. In certain situations, the involuntary conversion rules under section 1033 apply differently to property used in a trade or business and property held for personal purposes. This article focuses on trade or business property that has been damaged or destroyed in a casualty such as Hurricane Harvey.[2]

Overview of Casualty Losses and Gains

If tangible property has been damaged or destroyed, the taxpayer first must determine whether the damage resulted from a "casualty"—an event that is sudden and unexpected, such as a fire, storm, or shipwreck. If a casualty has occurred, the taxpayer must then determine whether it has realized a casualty loss potentially deductible under section 165(a) or a casualty gain that may be deferred under section 1033 as an involuntary conversion.

Under section 165(a), a taxpayer is generally allowed a deduction for any casualty loss sustained during the tax year that is not compensated for by insurance or some other form of compensation.[3] The amount of loss to be taken into account under section 165(a) is the lesser of:

- The change in fair market value of the property due to the casualty event (the difference in the damaged property's fair market value before and after the casualty), or
- The adjusted tax basis of the property.[4]

However, if business property is completely destroyed by casualty, the casualty loss equals the adjusted tax basis of the property, even if the fair market value of the property is less than its tax basis.[5]

After determining the potential casualty loss under section 165, the taxpayer must reduce the potential loss (but not below zero) for the amount of any insurance proceeds or similar compensation for the property to arrive at the casualty loss deduction allowable under section 165. If the insurance proceeds or other compensation for the property exceeds the amount of the potential loss (i.e., the insurance reduced the amount calculated under section 165 to zero), the taxpayer has no casualty loss deductible under section 165(a).[6]

Instead, to the extent the insurance proceeds or other compensation exceeds the adjusted tax basis of the converted property, the taxpayer realizes a "casualty gain" for U.S. federal income tax purposes.

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[2] In addition to the damage or destruction of property, the involuntary conversion rules of section 1033 apply to other situations in which a taxpayer is deprived of its property (e.g., theft, condemnation, or seizure) and realizes a gain for U.S. federal income tax purposes. This article is limited to a discussion of section 1033 in connection with an involuntary conversion that arises because of damage or destruction to property.

[3] Section 1.165-7(a)(1).

[4] Section 1.165-7(b)(1).

[5] *Id.*

[6] Section 165(a); section 1.165-7(b).

The gain realized from the casualty is considered to be gain from the disposition of the converted property and is taxed accordingly. However, the taxpayer may elect under section 1033 to defer the current recognition of the gain if it can satisfy certain requirements for deferral.[7]

The basic principles around this election to defer gain and the requirements to qualify for deferral under section 1033 are explored below.

Overview of the Section 1033 Requirements

If the taxpayer's property is damaged or destroyed in a casualty event and, as a result, involuntarily converted into money (e.g., insurance proceeds), the taxpayer's gain, if any, is recognized *unless* the taxpayer satisfies the requirements of section 1033(a)(2). The requirements under section 1033(a)(2) to defer the gain realized fall into three basic categories:

- Election and Required Reporting. The taxpayer must *elect* to defer the gain and *report* all the details in connection with the involuntary conversion of property, including those related to the replacement of the converted property, or a decision not to replace, or the expiration of the period for replacement, in the return for each taxable year in which any of the gain is realized.[8]

- Qualified Replacement Property. The *same taxpayer* must *purchase* property that is *similar or related in service or use* to the converted property ("qualified replacement property") *with the intent to replace* the converted property.[9]

- Replacement Period. The taxpayer must complete the purchase *within the period of time* set forth in the statute.[10]

Thus, the ability of a taxpayer to defer gain under section 1033 depends, in large part, on the purchase of the appropriate replacement property, the timing of the purchase, and the disclosures made to the IRS regarding the transaction.

The Election and Required Reporting

A taxpayer may affirmatively elect to defer its gain realized from an involuntary conversion by attaching a statement to its tax return for each year in which gain is realized indicating the election is being made. The affirmative election statement must include all the details in connection with the involuntary

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[7] A taxpayer is *required* to defer its gain realized if the taxpayer's property is involuntarily converted *directly* into property that is similar or related in service or use to the converted property. The taxpayer cannot elect to recognize the gain. Section 1033(a)(1). It is unlikely in the case of a casualty that the taxpayer's property will be converted directly into similar use property. Accordingly, the rules related to direct conversions of property are outside the scope of this article.

[8] Section 1033(a)(2)(A); section 1.1033(a)-2(c)(2).

[9] Section 1033(a)(2)(A); section 1.1033(a)-2(c)(1).

[10] Section 1033(a)(2)(B); section 1.1033(a)-2(c)(3).

conversion of property, including those related to the replacement of the converted property, a decision not to replace, or the expiration of the period for replacement.[11]

To qualify for deferral, however, an affirmative election with the IRS is not required. The failure to include gain in gross income on the tax return for each year in which gain is realized is deemed to be an election by the taxpayer to defer the gain even if the details in connection with the conversion are not reported on the tax return.[12]

A taxpayer that defers gain under section 1033 must also designate the qualified replacement property on its tax return for the year the replacement property is purchased. If gain is realized and deferred in the year of purchase, the designation of replacement property is generally made as part of the statement providing the details of the involuntary conversion.[13] If the purchase of replacement property, however, occurs in a year in which none of the gain is realized, the taxpayer must attach a statement to the tax return for the year of acquisition which provides all of the details in connection with the replacement.[14] Accordingly, although the IRS does not require an affirmative election for deferral under section 1033, the IRS does expect to be notified when the taxpayer purchases replacement property on the tax return for *each taxable year* in which replacement property is acquired.

As described more fully below, the IRS has previously asserted that the failure to notify the government timely of the acquisition of replacement property on its *original* tax return for the year of acquisition indicates that the taxpayer did not acquire the property with the intent to replace the property that was converted. The IRS concluded that the property was not qualified replacement property.[15] Thus, the failure to notify the IRS timely of the purchase of replacement property could adversely affect the qualification of the purchased property as replacement property.

It is also important to note that once deferral under section 1033 is elected, either affirmatively or by omitting the gain from the tax return, the statute of limitations for assessment of tax for each tax year in which the taxpayer realizes gain from the conversion remains open for at least three years after the taxpayer notifies the IRS of replacement, of a decision not to replace, or of a failure to replace.[16] If the taxpayer defers gain from an involuntary conversion of property and fails to notify the IRS of replacement or a decision not to replace, the taxpayer's tax return for each year in which the gain was realized remains open *indefinitely* with respect to the deferred gain. Accordingly, care should be taken to report the purchase of qualified replacement property to the IRS on a timely filed, original return for the year of acquisition.

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[11] Section 1.1033(a)-2(c)(2).

[12] *Id.*

[13] *Id.*

[14] *Id.*

[15] FSA 200147053 (Nov. 23, 2001).

[16] Section 1033(a)(2)(C); section 1.1033(a)-2(c)(5).

Qualified Replacement Property Requirement

To qualify for deferral under section 1033, the *same taxpayer* must *purchase* property that is *similar or related in service or use* to the converted property *with the intent to replace* the converted property

The Same Taxpayer Requirement

The taxpayer who owned the converted property and suffered the involuntary conversion must be the same taxpayer who acquires the qualified replacement property. The taxpayer, however, may acquire the qualified replacement property in an entity that is disregarded as separate from the taxpayer for U.S. federal income tax purposes.[17]

If the taxpayer is a corporation, the qualified replacement property must be purchased by that corporation (or a corporation that is a successor to the taxpayer in a transaction subject to section 381(a)).[18] The purchase of qualified replacement property by any other entity, including the parent or other affiliate of the taxpayer, is not sufficient for section 1033 purposes.[19]

If the taxpayer is a partnership, the qualified replacement property must be purchased by the partnership. A purchase by the partners of the partnership is not sufficient.[20] If a partnership divides under section 708(b)(1)(B), however, each surviving partnership that is considered a continuation is generally treated as the "taxpayer" with respect to the share of section 1033 proceeds that it receives in the division and can make a qualifying replacement under section 1033.[21]

The Purchase Requirement

To be qualified replacement property, the taxpayer must acquire the property by "purchase" within the meaning of section 1033(a)(2)(A)(ii). A taxpayer is considered to have purchased the replacement property only if the taxpayer's adjusted tax basis in the replacement property would be its cost under section 1012, if section 1033 did not apply to the transaction.[22] Accordingly, property received as a gift, in a like-kind exchange under section 1031, or in certain corporate transactions may not qualify as purchased property for purposes of section 1033 because the tax basis of the property is determined under a provision of the Internal Revenue Code other than section 1012.[23]

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17 PLR 199945038 (Nov. 12, 1999); PLR 199909054 (Mar. 5, 1999).

18 Section 381(c)(13); Rev. Rul. 73-72, 1973-1 C.B. 368; Rev. Rul. 56-636, 1956-2 C.B. 522.

19 TAM 9051001 (Dec. 21, 1990) (concluding that corporations that file a consolidated tax return for U.S. federal income tax purposes are still separate taxpayers for purposes of section 1033).

20 TAM 9645005 (Nov. 8, 1996).

21 PLR 8244124 (Aug. 9, 1982).

22 Section 1033(a)(2)(A)(ii).

23 Section 1012(a); Rev. Rul. 69-639, 1969-2 C.B. 161; FSA 1994 WL 1866052 (IRS FSA) (Dec. 15, 1994) (concluding that the acquisition of assets in a D reorganization did not result in a cost basis under section 1012); TAM 8205005 (Oct. 23, 1981) (incurring deductible expenses, rather than capitalized costs, is not a purchase within the meaning of section 1033(a)(2)(A)(ii)).

Moreover, as a general rule, a taxpayer may not purchase qualified replacement property from a person related to the taxpayer (within the meaning of section 267(b) or section 707(b)), unless the related person acquired the property from an unrelated person during the taxpayer's replacement period.[24]

Example: Fayette Corp's property was completely destroyed as a result of Hurricane Harvey on August 23, 2017. In 2010, Jefferson Corp, an entity related to Fayette Corp within the meaning of section 267(b), purchased property that is similar or related in service or use to Fayette Corp's converted property. In January, 2018, Jasper Corp, another entity that is related to Fayette Corp within the meaning of section 267(b), acquires from an unrelated third party other property that is also similar or related in service or use to Fayette Corp's converted property.

Under section 1033(i), because Jasper Corp acquired the similar use property from an unrelated party during the replacement period for Fayette Corp's involuntary conversion, Fayette Corp may purchase the similar use property from Jasper Corp as qualified replacement property. Fayette Corp, however, may not purchase the similar use property from Jefferson Corp as qualified replacement property.

The Similar Use Requirement

To be qualified replacement property, the taxpayer generally must purchase property that is "similar or related in service or use" to the converted property.[25] Neither the Code nor the regulations provide a specific definition of the phrase "similar or related in service or use" for purposes of section 1033. The IRS has articulated two approaches for determining whether a replacement property satisfies the similar use standard: a functional use test and a relationship test. Under each approach, the focus is on the similarity in the relationship between the taxpayer and the properties.

- Functional Use Test. If the taxpayer owned and operated the converted property, the IRS generally applies a functional use test, focusing on the physical characteristics and the taxpayer's end use of the properties. Under this test, property is not considered similar or related in service or use to the converted property unless the physical characteristics and end uses of the converted and replacement properties are closely similar.[26]

- Relationship Test. If the taxpayer is an investor in the property (e.g., the taxpayer leases the property for use by others), the IRS generally applies a relationship test. Rather than focusing on the use to which the property is put by the lessee or user of the property, this test focuses on the taxpayer-owner's relationship to the property. In applying this test, the IRS considers whether the properties are of a similar service to the taxpayer, the nature of the business risks connected with

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[24] Section 1033(i). A taxpayer (other than a C corporation or a partnership in which one or more C corporations own more than 50 percent of the capital or profits interests) is not subject to the related party limitation in section 1033(i)(1) if the aggregate amount of gain realized with respect to property that is involuntarily converted during the taxable year is $100,000 or less. Section 1033(i)(2)(C).

[25] Section 1033(a)(2)(A).

[26] Rev. Rul. 64-237, 1964-2 C.B. 319.

the properties, and what the properties demand of the taxpayer in the way of management, services, and relations to the tenants.[27]

Similar to the approach of the IRS, the courts have generally interpreted the similar use standard to require a reasonable degree of continuity in the nature of the assets as well as the general character of the business conducted by the taxpayer. While the replacement property does not need to duplicate, or be identical to, the converted property, the replacement property should be a reasonably similar continuation of the taxpayer's prior commitment of capital and not a departure from it and should be made in substantially similar business property. As a relief provision, section 1033 allows a taxpayer whose enjoyment of property has been interrupted without consent to have that interruption ignored for tax purposes if the taxpayer returns as closely as possible to its original position.[28]

The following are examples of factual situations that satisfy the similar use standard:

- Improvements or repairs made to remaining property to enable the property to continue in operation at its original capacity;[29]
- Improvements made to damaged property to prevent another conversion;[30] and
- A gas station held as rental property replacing land and a warehouse that was also held as rental property.[31]

Corporate Stock or Partnership Interests as Similar Use Property

Under section 1033(a)(2)(A), qualified replacement property includes the purchase of stock in the acquisition of control of a corporation that owns similar use property. For this purpose, "control" is defined as the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock.[32] The corporation should own the similar use property at the time the stock is acquired by the taxpayer as replacement property[33] and the corporation's assets should consist "principally" of similar use property that was not owned by the taxpayer immediately before the acquisition of the stock.[34]

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27 Liant Record Inc. v. Commissioner, 303 F.2d 326 (2d Cir. 1962); Rev. Rul. 64-237, 1964-2 C.B. 319.

28 *See, e.g.,* Maloof v. Commissioner, 65 T.C. 263 (1975).

29 Rev. Rul. 67-254, 1967-2 C.B. 269.

30 Rev. Rul. 60-69, 1960-1 C.B. 294.

31 Rev. Rul. 71-41, 1971-1 C.B. 223.

32 Section 1033(a)(2)(E)(i).

33 Rev. Rul. 77-422, 1977-2 C.B. 307; GCM 36059, 1974 WL 35830 (Oct. 22, 1974). *But see,* John Richard Corp. v. Commissioner, 46 T.C. 41 (1966); *acq.* 1967-2 C.B. 3, *acq. withdrawn and nonacq.,* 1974-2 C.B. 5 (allowing the taxpayer to contribute cash to a corporation that was used to acquire the similar use property as part of an integrated transaction).

34 Templeton v. Commissioner, 66 T.C. 509 (1976); 67 T.C. 518 (1976); 573 F.2d 866 (4th Cir. 1978); Kahl v. Commissioner, T.C. Memo 1986-240 (disallowing section 1033 deferral when less than 25 percent of the corporation's assets were similar use property); Rev. Rul. 69-242, 1969-1 C.B. 200 (implying that section 1033 deferral would be available for stock of a corporation 75 percent of whose assets were similar use property).

Unlike stock in a corporation, section 1033 does not specifically authorize the acquisition of an interest in a partnership as qualified replacement property. Thus, the IRS has concluded that the purchase of an interest in a partnership is not the purchase of qualified replacement property for purposes of section 1033, even if the partnership owns and operates property similar or related in service or use to the converted property.[35]

If, however, the acquisition of the partnership interest is governed by Revenue Ruling 99-6,[36] the taxpayer will be treated as acquiring the selling partner's share of the partnership's assets for U.S. federal income tax purposes, rather than a partnership interest. Thus, in a transaction subject to Revenue Ruling 99-6, the legal acquisition of partnership interests should qualify as the purchase of qualified replacement property to the extent of the selling partner's share of the similar use property held by the partnership.

Special Rule for Presidentially Declared Disasters

For taxpayers who owned property that was (1) held for productive use in a trade or business or investment, (2) located in a presidentially declared disaster area, and (3) involuntarily converted as a result of the presidentially declared disaster, a special rule applies for purposes of determining what is qualified replacement property. Under this special rule, *any tangible property* that is of a type held for productive use in a trade or business is considered to be property that is similar or related in service or use to the converted property.[37]

A presidentially declared disaster is any disaster subsequently determined by the President of the United States to warrant assistance by the Federal Government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act. The disaster area is the area determined to warrant such assistance.[38]

Hurricanes Harvey, Irma, and Maria resulted in presidentially declared disasters in several regions of the United States, Puerto Rico, and the Virgin Islands. For taxpayers who lost business or investment property that was located within the disaster area,[39] section 1033(h) significantly expands the potential property that is considered similar or related in service or use to the converted property to any tangible business property.

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[35] Rev. Rul. 55-351, 1955-1 C.B. 343.

[36] 1999-1 C.B. 432. *See also* Rev. Rul. 70-144, 1970-1 C.B. 170; PLR 7933079 (May 21, 1979).

[37] Section 1033(h)(2).

[38] Section 1033(h)(3); section 165(i)(5).

[39] For a list of covered disaster areas, please see www.FEMA.gov/disasters; TX-2017-09 (as updated Sept. 20, 2017); VI-2017-01 (as updated Sept. 19, 2017); PR-2017-01 (as updated Sept. 19, 2017); FL-2017-04 (as updated Sept. 15, 2017); GA-2017-02 (Sept. 19, 2017); PR-2017-02 (Sept. 22, 2017).

The Intent Requirement and Notification of Replacement

To be qualified replacement property, the taxpayer must acquire the property with the "intent to replace" the converted property.[40] While this requirement is typically not a stumbling block for most taxpayers,[41] it is advisable to document the taxpayer's intent for purchasing the property at the time of its acquisition.[42]

In addition, the IRS has concluded that a taxpayer demonstrates its intent by timely and properly reporting the acquisition of the replacement property on its tax return for the year of acquisition. If the taxpayer files its return for the year of purchase without reporting that the property is replacement property, the taxpayer "rather clearly indicates that the property was not purchased for the purpose of replacing involuntarily converted property."[43]

Moreover, the IRS takes the position that this designation of replacement property must be on the taxpayer's original return for the year of purchase. The IRS recently did allow a taxpayer to designate property as qualified replacement property on an amended return for the year of purchase. The facts of the ruling were unique and the taxpayer's replacement intent was clearly established by those facts.[44] As a general rule, however, the IRS has concluded that a taxpayer may not amend its tax return for the year of acquisition to designate previously acquired property as replacement property.[45]

The Replacement Period

The purchase of qualified replacement property must occur during the replacement period specified in section 1033. The replacement period generally begins on the date of the disposition of the converted property. With respect to a casualty, the date of disposition is generally the date of the casualty event.[46]

For most involuntary conversions, the replacement period ends *two years* after the close of the first tax year in which any part of the gain upon the conversion is realized.[47] If a taxpayer receives insurance proceeds over a period of time, the first tax year in which the taxpayer is treated as realizing a gain from the conversion is generally the first tax year in which the taxpayer receives (or properly accrues) insurance proceeds in an amount that exceeds the tax basis of the converted property.

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40 Section 1033(a)(2).

41 Unique issues regarding the intent could arise for a taxpayer who routinely purchases property in the ordinary course of its trade or business. *See, e.g.,* Rev. Rul. 59-8, 1959-1 C.B. 202 (concluding that planting a new crop was not the purchase of replacement property); *modified by* Rev. Rul. 81-279, 1981-2 C.B. 163, (allowing a taxpayer who adopted the crop method of accounting to treat the cost of planting a new crop as the acquisition of replacement property); Rev. Rul. 62-161, 1962-2 C.B. 175 (allowing the acquisition of land and planting of new trees to replace a converted orchard).

42 Rev. Rul. 83-39, 1983-1 C.B. 190.

43 GCM 38694, 1981 WL 169592 (IRS GCM); FSA 200147053 (Nov. 23, 2001).

44 PLR 201240006 (Oct. 5, 2012).

45 FSA 200147053 (Nov. 23, 2001).

46 Central Tablet Manufacturing Co. v. United States, 417 U.S. 673 (1974).

47 Section 1033(a)(2)(B).

For certain extraordinary events, Congress has extended the replacement period. [48] As of the date of this article, no legislation has been passed extending the replacement period for Hurricanes Harvey, Irma, or Maria. However, the National Disaster Tax Relief Act of 2017 has been introduced and, if passed, would extend the replacement period to five years for property damaged or destroyed in a presidentially declared disaster.[49]

A taxpayer may apply to the IRS to extend the replacement period for any involuntary conversion. The application must show reasonable cause for why the converted property could not be replaced during the replacement period. The taxpayer generally must apply for an extension before its general replacement period expires.[50]

The replacement period is not automatically extended simply because the taxpayer expects to receive additional compensation for the property after the close of the replacement period or because the taxpayer is in litigation with another party regarding the proper compensation. In the event that the taxpayer expects additional proceeds after the close of the replacement period (and the taxpayer does not request an extension of time to replace), the taxpayer must "anticipatory-replace" during the replacement period if the taxpayer wishes to defer 100 percent of its gain realized. The taxpayer does not automatically receive an extended replacement period or a second replacement period when the receipt of insurance proceeds or other consideration extends beyond the replacement period.[51]

<u>Example</u>. Monroe Corporation's business facility was completely destroyed by Hurricane Irma on September 11, 2017. Monroe Corporation's insurance claim was settled and proceeds received in January 2018. Monroe Corporation can begin purchasing qualified replacement property on September 11, 2017 (the beginning of the replacement period). Unless an extension of time to replace the destroyed property is obtained, Monroe Corporation, a calendar year corporation, must complete the purchase of its qualified replacement property no later than December 31, 2020 (two years from the close of the first tax year in which Monroe Corporation realized a gain (2018)).

Business Interruption Insurance

Amounts received from an insurance policy that insures against the loss of net profits are not compensation for the loss of property and thus, are not proceeds of an involuntary conversion under section 1033. Recoveries under such policies, often referred to as use and occupancy insurance or

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[48] Section 1400L (extending the replacement period to five years after the terrorist attacks on September 11, 2001); Section 405, PL 103-73 (H.R. 3768) September 23, 2005 (extending the replacement period to five years after Hurricane Katrina).

[49] Section 301, National Disaster Tax Relief Act of 2017, H.R. 3679, 115th Cong. 1st Sess. (2017). If passed, the extended replacement period would be effective for disasters declared after December 31, 2015.

[50] *See* section 1.1033(a)-2(c)(3).

[51] A taxpayer generally has only one replacement period for a specific casualty event. Section 1033 does not permit multiple replacement periods in connection with a single conversion, even if proceeds are received after the expiration of the original replacement period. *See, e.g.,* Shipes v. Commissioner, T.C. Memo 1997-304; In re Mahon, 1998 WL 953984 (M.D.Fla).

business interruption insurance, generally are taken into account in the same manner that the profits for which they are substituted would have been (e.g., ordinary income).[52]

Apportioning the Recovery

For those taxpayers with complex insurance arrangements or policies that cover several types of losses, careful consideration should be given as to how the eventual recovery may be apportioned among the various covered items. Often an insurance company will provide a lump-sum payment to the insured without specifically ear-marking particular amounts to the claims submitted. In that case, it is left to the insured to determine the extent to which it recovered insurance on a specific property claim or for other covered items, like lost profits.

The IRS generally allows the taxpayer to apportion its recovery if the taxpayer can demonstrate a reasonable basis for doing so.[53] Accordingly, in planning for the recovery of insurance proceeds or other compensation in an involuntary conversion for which section 1033 deferral may be desired, taxpayers are wise to develop the facts and circumstances surrounding the converted property, the claims submitted, and recoveries received to support the allocation of the insurance or other recovery among the converted property and other entitlements. This development may include contemporaneous documentation of the fair market values and adjusted tax bases of the converted property and estimates of the lost profits. Similarly, the taxpayer should carefully consider the manner in which its insurance claims are submitted with respect to the damaged or destroyed property, business interruption, and any other covered loss. Careful documentation should provide the taxpayer with a reasonable basis to allocate its eventual insurance recovery between claims for business interruption insurance or other non-property compensation and consideration for the various items of property converted.

Next Steps

The election to defer gain under section 1033 provides much needed relief to a taxpayer who loses property under circumstances outside of its control. Benefitting from that relief, however, requires the taxpayer to navigate a myriad of requirements and disclosure requirements. In addition, a clean and clear development of the facts surrounding the conversion, the taxpayer's recovery of insurance or other compensation, and the taxpayer's replacement of any damaged or destroyed property will be critical to obtaining the deferral provided under section 1033.

KPMG professionals can assist our clients who were affected by the recent natural disasters with determinations of whether section 1033 is applicable to the transaction, the proper timing of gain

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[52] Section 1.1033(a)-2(c)(8).

[53] Rev. Rul. 70-465, 1970-2 C.B. 162 (concluding that the IRS will not rely on the decision in Bymaster v. Commissioner, 20 T.C. 649 (1953), to deny the allocation of proceeds and gain in an involuntary conversion when the taxpayer establishes an adequate basis for the allocation); PLR 199952082 (Dec. 29, 1999). *See also* Horowitz Bros. v Commissioner, 10 T.C.M. (CCH) 698 (1951). *But see* Bymaster v. Commissioner, 20 T.C. 649 (1953). *See also* Asjes v. Commissioner, 74 T.C. 1005 (1980); Kendall v. Commissioner, 31 T.C. 549 (1958); M.I.C. Ltd v. Commissioner, T.C. Memo 1997-96.

realization and deferral elections, and most importantly, the monitoring of all required disclosures to the IRS. For those clients who may eventually need more time to acquire the replacement property, KPMG professionals can work with the client and the IRS to obtain extensions of time to replace the converted property. In addition, KPMG professionals can assist the client with the property valuations and any necessary accounting and systems requirements that may be necessary to track and document compliance with section 1033. In short, we can lead our clients through the myriad of requirements enabling them to obtain the relief offered by section 1033 and take some of the sting out of the gain.

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